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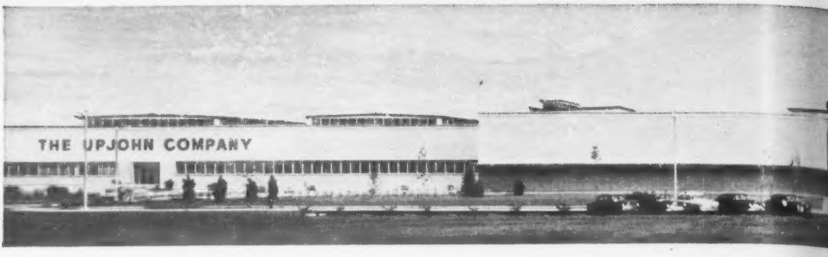

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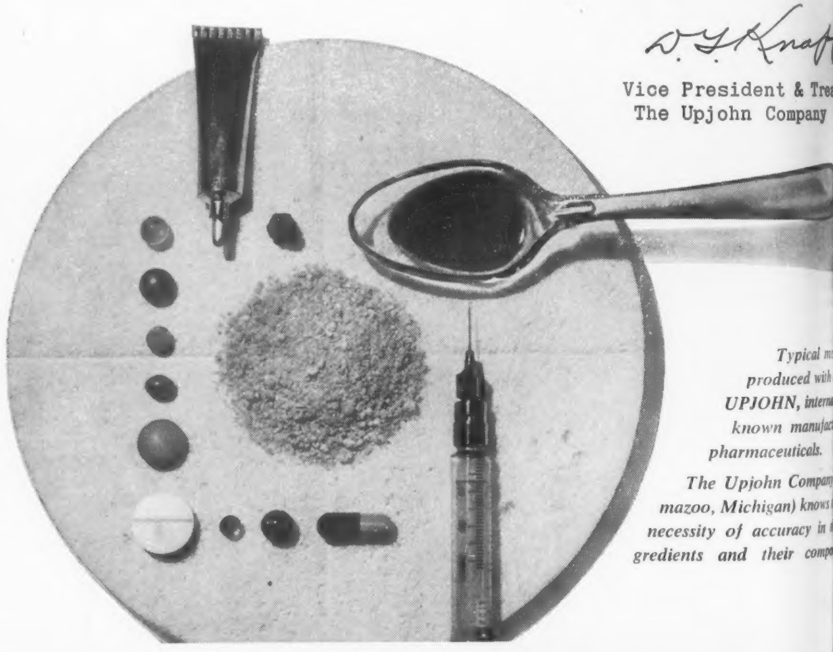

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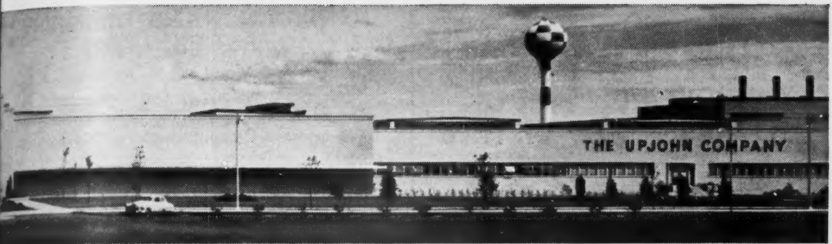

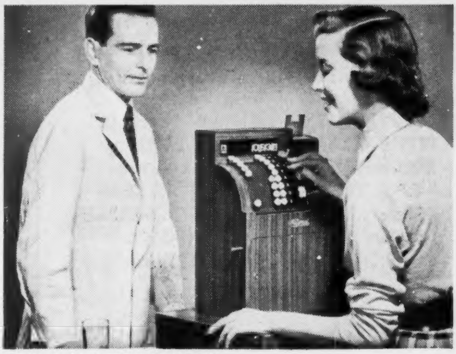

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The Board of Directors of the Society has authorized the Committee on Publications to conduct a prize essay contest among seniors and graduate students majoring in accountancy, duly enrolled in the colleges of New York State. The article may cover any topic in the field of accounting and/or auditing.

Prizes in the amount of $100 for the best article and $50 for the second best article are offered. In addition, the two winners and any others submitting papers worthy of honorable mention will receive a one-year subscription to *The New York Certified Public Accountant.*

The General Rules of the Contest are as follows:

All papers shall be original, and the manuscript shall be typed in duplicate on 8½ x 11 stationery on one side, double or triple space typing, and shall not be more than 6,000 words in length. Each contestant shall indicate the exact number of words in his paper at the end thereof.

★

The name of the individual submitting the paper shall not appear thereon, nor should there be any other means of identifying the manuscript, which should be accompanied by a covering letter giving the contestant's name and address. When submitted to the judges, each manuscript will be given a key number for identification.

★

Manuscripts should be forwarded to The Managing Editor of *The New York Certified Public Accountant,* 677 Fifth Avenue, New York 22, N. Y., on or before May 15, 1952. Awards will be announced as soon thereafter as possible.

★

All papers submitted shall become the property of the New York State Society of Certified Public Accountants and shall be available for publication in *The New York Certified Public Accountant.* The decision of the judges shall be final as to what papers, if any, may be entitled to prizes.

THE NEW YORK CERTIFIED PUBLIC ACCOUNTANT

EMANUEL SAXE, *Managing Editor*

The matters contained in this publication, unless otherwise stated, are the statements and opinions of the authors of the articles, and are not promulgations by the Society.

VOL. XXII — *March • 1952* — NO. 3

An Accountant's First Visit to a Textile Weaving Mill

By SIDNEY C. FRIED, C.P.A.

This article, in breezy, narrative style, presents the descriptive background material necessary to an understanding of textile weaving processes. It thus paves the way for better comprehension of the two technical papers that follow.

THE hero of this epic is one Percy Veerance, supervising staff accountant of the firm of Zero, Balance and Crossfoot, Certified Public Accountants of New York City. It is through his eyes that we shall have a ring-side seat and view the panorama of events occurring during an accountant's initial trip to a textile weaving mill. The firm has recently acquired a new account, the Southern Weaving Corp., and we find our seeing-eye accountant heading toward the Carolinas via rail. As this will be his first audit, not only of the new account, but of any firm in this industry, he must first obtain all the necessary background data upon which to build his audit program. As he sits in the train, he plans his approach to this phase of the problem. A glance at his worksheet reveals a logical plan of attack:

Step 1: Establish the basic facts about the plant—

(a) Products manufactured
(b) Physical plant and equipment
(c) Number of employees and organization chart.

Step 2: Review all books of record in the office and establish the purpose of each.

Step 3: Take a trip through the plant, following the actual flow of the product through each department.

Step 4: Review the flow of paper work between office and plant.

Step 5: Review the system of internal control.

SIDNEY C. FRIED, C.P.A., has been a member of the Society since 1940 and served during 1950-1951 as Chairman of the Committee on Textile Accounting. He is actively engaged in the Textile Industry as Vice-President and Comptroller of the Martin Weiner Corporation, integrated rayon manufacturers. He is also a member of the Controllers Institute of America and the American Management Association.

This paper was presented by him at a technical meeting of the Society conducted last year at the Engineering Auditorium under the auspices of the Committee on Textile Accounting.

Products Manufactured

Upon his arrival at the plant, our central character is greeted by the plant superintendent. From conversations with him, Percy obtains the data previously outlined in Step 1. The mill weaves broad, filament rayon, apparel fabrics. Among others it carries in its line such basic fabrics as 114 x 68—100 Denier crepe and 92 x 68 pigment taffeta. The superintendent explains that the designation "114 x 68" or "92 x 68" indicates the actual construction of the cloth. The first figure refers to the number of yarns to the inch in the lengthwise warp, whereas the second figure designates the number of yarns to the inch in the crosswide filling. Full construction data also includes information concerning the size and type of yarns used in the warp and filling.

Plant, Equipment and Personnel

The plant itself is a one-story mill building of some 100,000 sq. feet in area. It houses 500 looms, auxiliary equipment, and a staff of about 250 employees.

Books and Records

The superintendent then turns Percy over to the office manager and our hero brings into play Step 2 of his master plan. He learns that the mill office concerns itself only with branch accounting, which in this case includes payroll, purchase of mill supplies, and material accounting. Raw yarn purchases are made from the home office in New York and the general corporate ledgers are also maintained there. Percy asks if he may see all the books of record and they bring him the following:

(a) Purchase Book
(b) Cash Disbursement Book
(c) Accounts Payable Ledger
(d) Payroll Register
(e) Petty Cash Book
(f) Raw Yarn Record
(g) Warp Book
(h) Supply Records
(i) Yarn Clearance Records

Items (a) through (e) are the usual accounting records used for these purposes and require no special mention. The *Raw Yarn Record* is a perpetual inventory of unopened cases of yarn, classified by quality and code of yarn.

The *Warp Book* is a record of each warp prepared and its disposition.

Supply Records are perpetual inventories of the more important machine parts maintained in the stock room.

Clearance Records consist of calculations accounting for all the yarn, from the time received to the time shipped. These calculations are controls indicating that the yarn was transformed into fabric according to construction formula, that there was no excessive waste, damage or pilferage, and that the physical inventory on hand at the end of the accounting period is accurate for all practical purposes.

Flow of Product Through the Plant

The next step of the plan called for a trip through the plant and Percy arranges with the superintendent for a guide to take him from department to department, following the actual flow of the product. Raw yarn is received and stored in the yarn stock room. It is generally received on cones of 3 to 5 pounds in weight. From this point the yarn goes to the first production department—warping.

Warping: In the warping operation, the single filaments of yarn are taken from the cone and arranged in a continuous wide sheet of yarns, in which the filaments are spread equally apart, lie parallel to each other, and are in the same horizontal plane. *Warp* is the term used to designate the lengthwise yarns in a piece of fabric. The term *sley* is frequently heard in textile circles. It refers to the number of filaments to the inch in a warp. There are two types of warping, one known as the *Silk System* and the other as the *Cotton System*. A silk system

warping machine consists basically of a magazine cone creel, a large cylindrical reel and a beaming stand. The cones of yarn are placed on the *creel,* which can accommodate 1,000 or more cones. The yarn ends are drawn forward through suitable reeds and are wound in a yarn sheet about 8 inches wide on the large reel which has a circumference of about 8 yards. Additional 8 inch sections are placed side by side on the reel until the desired width of the warp is completed. The 114 x 68—100 Denier construction has a warp of about 5,500 ends. The 92 x 68 pigment taffeta has a warp of about 4,000 ends. From the large reel, the full width of warp is redrawn onto a *loom beam* in the desired length. A warp may run from 2,000 to 5,000 yards in length. A 3 pound cone of 125 denier rayon has approximately 107,000 yards of yarn. If the warper averages 200 yards per minute, the cone will last some 9 to 10 hours. The creel must then be re-banked every 10 hours.

A cotton system warper differs from the silk system warper in that the yarns are drawn directly from the creel onto a direct beamer. Section beams of from 400 to 800 ends are prepared and up to lengths of 50,000 yards. Several section beams are then re-drawn on the cotton slasher to make the desired width and length on the loom beam.

Slashing and Sizing: Following the warping operation it is necessary to size the warp in the slashing department. This is accomplished by passing the warp through a gelatinous solution and then over a series of dry cans. By so doing a moderate stretch is imparted to the yarn. This is an important point to keep in mind in accounting for the yarn in a clearance calculation. The purpose of impregnating the yarn with the sizing solution is to increase its strength and minimize breakage due to chafing at the loom. For the 100 Denier and 92 x 68 qualities, sizing gain will run approximately 5% each.

As in warping there are two types of machines for sizing, one designed to run silk-system warps and the other cotton-system warps. The silk-system sizer will take the loom beam as made at the warper and redraw it through the size solution, then over dry cans and onto another loom beam. The cotton-system machine may be differentiated from the other by use of the word "slasher". *Slashing* is the operation of drawing yarn from several section beams, assembling them in parallel order and in a continuous sheet having a desired number of filaments or ends of equal length, and winding them onto a loom beam. Slashing also includes the operation of *sizing* as a suitable application of size solution is made to the yarns as they are drawn from the section to the loom beams. Dry cans are similarly used on the slasher to dry the impregnated yarn. The size solution used must not only be capable of penetrating, coating and protecting each filament of yarn, but it must be of such a nature as to be readily washed out in the finishing operation.

After sizing, the warp on the loom beam is entered through the reed and the harness and is then ready for mounting on the loom.

Quilling: Filling is the term used to designate the cross-wise yarns in a cloth. These cross-wise yarns are interlaced through the warp on the loom as the shuttle moves back and forth. In each shuttle is a quill of yarn. These quills of filling yarn are prepared on a quilling machine. The operation of *quilling* is the transferring of filaments of yarn from the original yarn package, usually the cone, onto a bobbin or quill. The bobbin is a small wooden elongated cylinder of from 6 to 8 inches in length and up to ½ inch in diameter. Modern quilling machines are highly automatic devices capable of positioning the empty quill, transferring the yarn, and then discharging the full quill. The operator's main function is to keep the machine amply supplied with yarn and quills and to remove full

quills as they are completed. Filling yarn is frequently tinted with a fugitive color to differentiate different lots and codes and to avoid errors in weaving.

Weaving: The weave shed itself is usually a separate closed room having neat rows of looms and controls for regulating the heat and humidity of the air. Most modern mills today provide automatic conditioning in their weaving department in that it permits of higher weaving efficiency and finer quality of product.

Weaving itself is the actual operation of interlacing the warp and filling yarns. The yarns interlace each other at right angles in a desired pattern. The quills containing the filling move back and forth through the warp at a speed of 172 picks per minute. The woven fabric is wound up on a wooden roll and when 100 yards or so is accumulated, it is cut off, creating what is known as a "piece". Each such piece is identified with a number. The usual numbering system is to utilize the warp number and the consecutive cut number. By so doing, each piece can be easily related back to its loom, warp and original yarn used. This is important in case of imperfections in quality which have to be traced back to their source. The natural operation of a loom in weaving a fabric creates a certain "take-up" or shrinkage in the length of the warp that may run as high as 8 to 10%. The 114 x 68—100 Denier crepe has a take-up of about 8-9%. The 92 x 68 pigment taffeta has a take-up of some 3%. This shrinkage in length of warp is important to the accountant in calculating costs or clearances. Woven fabric taken off the loom is termed *greige goods* and is ready for shipment to the mill's customers.

Flow of Forms between Office and Plant

While chatting at lunch with the plant superintendent and the office manager Percy steers the conversation around to the subject of the flow of paper work between the office and plant. If you recall, this was Step #4 in his master plan. The paper starts to flow with the receipt of raw yarn at the mill door. Notice of receipt is given to the office where the shipment is recorded in the Raw Yarn Record. Similar notice is forwarded to the New York office, where it is used to substantiate the purchase invoice and the contract. Yarn removed from the stock room is similarly recorded in the office's yarn record.

A Warp Card is prepared in the warp department for each warp before it is made. Each card recites all the pertinent data as to quality of yarn, construction, etc., and is numbered, *seriatim.* The Warp Card has two duplicate parts; one remains with the warp itself and the second is forwarded to the office. Each card has a companion Warp Sheet with the same number, upon which is recorded the data from the duplicate warp ticket. The office maintains a control on warp numbers so that no Warp Card is misplaced.

After the warp is placed in the loom, the warp ticket is removed and forwarded to the shipping room where it is filed. As each cut of greige goods is taken off the loom, it is sent to the shipping room. A notation is made on the respective warp card as to the consecutive number of the cut.

Shipping memoranda are prepared and the piece numbers are posted back to the warp book from a copy of the shipping record. When all the cuts have been posted to the warp sheet and the warp has been completed, the warp sheet is totaled. Comparisons are made as to the relationship of original warp yards to sized yards and also to woven yards.

The warp book is one facet of the internal control system for materials. A broader and more inclusive control of materials is the *Yarn Clearance Calculation.* These computations are generally made from one inventory pe-

(Continued on page 152)

Cost Procedures for a Textile Weaving Mill

By David Grossberg, C.P.A.

In this practical paper, the author explains how the management of a textile weaving mill predetermines the various elements of its weaving cost and periodically reconciles these estimates with its actual production costs.

Importance of the Textile Industry

Before extended discussion of weaving mill costs, it would be fitting to highlight the scope and importance of the textile industry. The manufacture of textiles in the United States is vast and expansive, ranking second in national industrial production. The textile industry utilizes not only the efforts of millions of workers, but the investment of vast sums of capital in its plants and buildings. It involves the fields of engineering, chemistry and art, and even possesses a terminology peculiar to itself. In the fabric it produces are embodied yarns from many diverse sources: wool and silk from the animal kingdom; cotton and linen from the vegetable; asbestos and glass fibers from minerals; and rayon and nylon from synthetics of the laboratory.

The textile industry can be divided into two major divisions—the manufacturing or processing group and the distributing-selling group. It is from the first group that we select our topic for discussion, the weaving mill. In this connection, we shall assume a smaller-sized mill, say of 250 looms engaged in weaving production.

David Grossberg, C.P.A. (New York and New Jersey) has been a member of the Society since 1948 and is currently serving on our Committee on Textile Accounting. He is also a member of the Controllers Institute of America.

Mr. Grossberg is actively engaged in the Textile Industry as Comptroller for Stern & Stern Textiles, Inc., manufacturers and importers of a wide variety of textile items. He was formerly engaged in public practice as a senior accountant with S. D. Leidesdorf & Co., C.P.A.'s.

This paper was presented by him at a technical meeting of the Society conducted last year at the Engineering Auditorium under the auspices of the Committee on Textile Accounting.

Basic Cost Principles and Procedures

The cost principles involved will generally apply whether the product is made of wool, silk, rayon or nylon. The cost procedures at such a mill fall within the classifications of Process Cost; that is, the manufacturing output consists of like or similar units. Costs may therefore be accumulated in bulk by operations or departments. The total costs by operations or departments when divided by the number of units produced will provide the cost of a single unit. Such basic unit may be expressed in terms of pounds processed or yards woven, or in picks produced. The basis to be used would depend on individual mill policy, and the most effective use of such a basis to the mill management. As a practical matter, so long as the costs are properly recorded, the information can be readily prepared or reassembled in whatever form required.

The cost procedure for a textile weaving mill serves two purposes. The first is that of gathering costs on an historical basis, showing what has taken place by operations and processes, and what the unit costs have been. The second, and principal function is that of providing a sound basis for preparing costs per unit on a predetermined or estimated basis where such estimate is determined for each pattern or style manufactured. In the examples which

follow, the mill is considered as one producing a variety of patterns. It would thereby utilize different types of yarn, different weights of each type, and have variations in the manufacturing process.

It is therefore obvious, in such a case, that the use of historical or overall average costs would never suffice. Such costs deal with the past. We must know what our present operations cost and project the knowledge and experience gained from historical costs so as to determine properly the cost of goods to be put into future production. Especially is this true in present-day economy, a time of fluid, irregular costs.

In the present discussion, it should also be borne in mind that many factors exist which affect each mill differently in calculating predetermined costs. Differences in wage rates, closeness to raw material markets, local tax rates, types of employee, age and efficiency of machinery, variations in management policy, must all be closely analyzed. Time limits even nominal consideration of these fine differences, but their existence must be stressed, since they each have an effect on correctly predetermined costs.

Predetermination of Weaving Costs

The predetermination of weaving costs by units, styles or patterns is localized on a Fabric Cost Sheet, showing estimated costs for each of the major elements of cost: Material, Labor and Overhead. It is assumed at this time that management has already planned for future production, through budgets and contract lists of what its requirements will be, both for goods to be stocked and on order for future delivery.

The fabric cost sheet on which the predetermined costs are recorded should indicate the kind of cloth to be manufactured, its construction, type of weave, kind of yarn used for warp and filler, number of picks, ends, reed width, and other essential information. One such type of form is submitted:

Fabric Cost Sheet

DATE *4/1/51* QUALITY *101A*
DESCRIPTION *Rayon Sheer*
WIDTH IN REED *46"*
YARDS PER C *106*
FINISHED WIDTH *40"*
REED *40/2* PICKS *70* ENDS *3680*
WARP
75 den. viscose/30 turns/30 filaments
EDGES —
FILLING
75 den. viscose/30 turns/30 filaments

POUNDS PER 100 YARDS
(Including Waste *3%*)

WARP	*10* lbs.	@	*$1.50*	*$15.00*
EDGES	—	@		
FILLING	*6*	@	*1.50*	*9.00*
	16 lbs.			*$24.00*

	COST PER YARD
Total Material	*$ .2400*
Warping	*.0050*
Warp Sizing	—
Twisting and Entering	*.0030*
Heddle Dropping	*.0010*
Edges	
Additional Cost due to Weaving Takeup *6%*	*.0005*
Quilling	*.0080*
Weaving	*.0200*
Picking and Examining	*.0040*
Shearing	*.0010*
Indirect Labor	*.0500*
Overhead	*.0500*
	$ .3825

Material Cost

The determination of the cost of yarn for a fabric can be obtained on the basis of pounds of yarn required for 100 yards of fabric in the following manner:

Yardage and Weight of Warp Required per 100 Yards: The number of

threads (ends) in the warp times 100 yards length (plus allowance for warp takeup factor less warp stretch factor) when divided by the number of yards which one pound of the yarn used in this warp will produce gives the warp poundage required. The number of yards which can be obtained from one pound of a particular yarn is readily abstracted from specially prepared tables. The number of ends can also be derived from the product of the number of dents per inch on the reed, the number of threads to each dent and the reed width in inches.

Yardage and Weight of Filler Required: The width of the fabric times the number of picks per inch times 100 yards, when divided by the number of yards to a pound of the filler yarn being utilized, will give the pounds of filler required. The total of the two calculations will give the net pounds required for the fabric. To these figures must be added the determined percentage of manufacturing waste of yarn.

The cost of the raw material per pound will be obtained from the accounting records. The proper keeping of such records, stores ledger, inventory control sheets and the like, requires no special reference here. The basis for yarn costs will depend on individual mill practice in conformity with accepted accounting principles.

Direct Labor

For the Fabric Cost Sheet, it is possible to estimate the direct labor costs from the details of the construction of the fabric.

In the warping operation it is determined how many bobbins are involved in banking; how many sections of 100 yards are concerned in running on and beaming; and the direct labor rates applied per unit. In quilling or quill winding, the number of quills required is multiplied by the labor rate per 100 quills. In the weaving operation, the fabric cost sheet will indicate how many picks are required for each yard, which then is multiplied by the weaver's rate for this pattern. Similarly, other direct labor costs per yard may be derived when we know the rates for entering 1000 ends, for sticking reeds per 1000 dents, for wire dropping on the heddles per 1000 heddles. Other usual direct labor costs are picking and examining and loom-fixing, for which hourly rates ordinarily exist. These can be allocated to the individual pattern on some basis best suited for management purposes, usually by departments. Adequate payroll analyses must be maintained for proper index of predetermination. Consideration must be given to such factors as repeat operations in entering a warp, and whether this is a machine or hand operation.

Indirect Labor and Other Overhead

Indirect labor predetermination is based on estimates made from the cost records and assigned to the pattern on a basis of direct labor cost per department or sometimes on an over-all production basis. Such costs may be expressed in terms of units as pounds processed, per 1000 ends drawn, per 1000 picks woven, per loom hour, 2nd per yard of cloth inspected. Plant administrative expenses may be applied per pattern on the basis of a percentage of manufacturing cost for the pattern, or the average cost of such expenses per unit processed; so much per yard or pick or even picks times yards produced. Estimates may be made for a full year's expenses, based on prior period costs, so as to give effect to possible variables, and then reduced to a weekly basis for allocation to departments and thence to patterns.

In determining the final cost to be used as a basis for establishing a proper selling price, consideration may also have to be given to the added cost of defective work, "seconds", experimentation, power failures, overtime, accelerated depreciation rates, and percentage of the operating capacity of the mill engaged in manufacturing the product. In some mills, accountants advocate the addition of replacement value of yarns to the cost of processing, for use in de-

termining the selling price which is entered directly on the Fabric Cost Sheet.

Reconciliation of Estimated and Actual Costs

The use of carefully prepared Fabric Cost Sheets renders additional service in the pricing of inventories. Furthermore, they can be used periodically as an over-all proof with the actual cost of labor and overhead of goods produced during a given period, in the manner of the following reconciliation:

Pattern or Style	Yards Produced	Predetermined Cost Rate, per yard		Total Predetermined Cost	
		Labor	Overhead	Labor	Overhead
A	1000	$.10	$.08	$100.00	$80.00
B	500	.08	.06	40.00	30.00
C	500	.07	.06	35.00	30.00
Total Production Cost-Predetermined				$175.00	$140.00
Actual Production Costs				160.00	138.00
Difference				$ 15.00	$ 2.00

Once established, this method of predetermining fabric costs can prove valuable in the preparation of detailed cost figures which might be required by governmental agencies in connection with renegotiation proceedings.

In conclusion, it is hoped that this discussion will serve to further our activities in the production and integration of practical textile accounting literature.

An Accountant's First Visit to a Textile Weaving Mill

(Continued from page 148)

riod to the next. If done properly, a clearance affords an excellent means of accounting for all yarn from receipt through all the manufacturing processes and out as the finished product.* Basically and briefly the "clearance" is a set of arithmetical computations which first translates yards of warp and woven cloth back into pounds of yarn and then attempts to prove that opening inventory plus receipts less shipments equals the closing inventory. This is done for each quality of yarn. Where mills run numerous different and complex constructions of cloth, clearances can become rather involved. However, they are very much worth the time and effort.

The system of internal control also provides for safeguards around the other two main financial activities of the mill, namely, purchasing of supplies and preparing the payroll. However, these do not represent any specialized problems and need not be covered here.

* * *

Having completed his survey, our accountant completes his audit of the books and records of the Southern Weaving Corp., packs his papers, bids his adieus and heads home.

* "Clearance Accounting for Textile Weavers and Converters," by Sidney C. Fried; *The New York Certified Public Accountant*, November, 1948, pages 816-819.

AN ADIRONDACK VIEW

It takes more than a ski cap to make a skier—you need some tough ski pants, too.

It takes more than a hill and a snow machine to make Ski Pisgah skiable—you need a thermometer that will go below thirty-two.

It takes more than a five-volume and a fourteen-volume tax service to prepare tax returns correctly—you need a typist with X-ray eyes that can locate tax forms that are printed enough alike so carbon copies will not have the tax paid figures in the taxes due lines. Perhaps some other abilities are needed.

Leonard Houghton, CPA
"Adirondack Chapter."

Are Standard Costs Practicable in a Textile Weaving Mill?

By Charles G. Johns, C.P.A.

Standard costs are both practical and effective in small and medium-sized textile weaving mills, concludes this author, who illustrates his point with several examples of standard labor cost determinations for such an enterprise.

Standard costs are intended to serve as a control for labor and production, and to be used as a basis for estimating costs and selling prices prior to the manufacture of the goods. In order for standard costs to be effective, they must be compared with actual costs, and adjusted, when necessary, to conform as nearly as possible with actual costs. When operating conditions remain constant as to production, and overhead distribution percentages require only minor changes, standard costs may be adjusted for wage fluctuations by simple arithmetical calculation.

The weaving operation by machine is similar in principle for all types of cloth, but a cotton sheeting mill presents fewer problems. For the purpose of illustration, take a mill of medium size which manufactures low grade sheeting generally used by the bag trade. Assume that it operates 650 looms and produces 20 million yards of cloth annually. The looms are of the same type and width and vary only slightly as to speed. The cloth is of low pick count, numbering less than 50 picks to the inch, and there are less than 10 constructions manufactured. Large quantities of one construction of cloth are produced without interruption, and the manufacturing operation, which is a continuous process, is complete from raw cotton to finished cloth. The cloth is sold in bulk to bag manufacturers in bales which contain from 1,500 to 2,000 yards.

The previous speaker has described the weaving operation in rayon cloth mills. In each instance, cloth was produced from yarn manufactured elsewhere. If the mill used as an example herein purchased yarn instead of manufacturing it, then, by reason of the sizeable production of few constructions of cloth, costs could be controlled in the absence of standards. Between raw cotton and weaving, various operations are necessary for the production of yarn. In the mill selected, however, 27,000 pounds of cotton are processed daily, and the spinning operation alone requires spinning frames with a total of 23,000 spindles.

After World War I the southern cotton textile mills experienced many unprofitable years, and became accustomed to keeping expenses as low as possible. Few of the small or medium-sized mil's had any cost system worthy of note, although estimates were usual-

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ly made with extreme care. In the mill to which reference is made, it was found that estimated costs were used and that the same procedure had been followed consistently for many years. Such estimates were in considerable detail and in general covered:

CARD ROOM:
- Loose cotton
- Picker laps
- Card sliver
- First drawing
- Second drawing
- Roving on spindles
- Cans of second drawing in creels

SPINNING ROOM:
- Slubber roving on creels
- Slubber roving in creels
- Warp on frames
- Warp in bins
- Filling yarn on frames
- Filling yarn in bins

WEAVE ROOM:
- Warp on looms
- Unsized warp on section beams
- Filling in boxes in weave room
- Filling in batteries in weave room
- Cloth on looms

Most of the estimates were based on actual payrolls and production records, but the overhead represented all expenses includible in this category reduced to a unit price per pound manufactured. Estimates were further extended to reach a unit price for each weight of yarn and each construction of cloth. These procedures may be found at present in many small and medium-sized mills where the plant manager compiles estimated unit prices. In view of the facts stated above, and inasmuch as some of the information required for costing is already being prepared, a standard cost system in this mill could be installed without difficulty. The questions are whether a standard cost system in this instance is practicable. What are the advantages and disadvantages of maintaining such a system?

Medium-sized mills are often not in a position financially to carry a large stock of finished goods and, where possible, the practice is to deliver the newly manufactured product from the cloth room to the railroad rather than to the warehouse. Where large orders are taken and prices quoted from 3 to 6 months in advance, it is obvious that estimates are necessary. Such estimates should be accurate and based upon actual performance over a longer time than the previous payroll period. Under these circumstances, standard costs which have been periodically checked, would be ideal for estimating purposes. Other advantages of standard costs would be (1) the control of costs in each department, (2) control of production, and (3) the costing of sales for use in preparation of earnings reports for short periods of time. A mere comparison of payrolls and production records—week by week, bi-weekly, or monthly—may be sufficient to satisfy the management, but such a method does not afford any real basis for control. If a standard was set for each department, and comparisons were made with the standard, then the comparison would be effective.

In all instances, whether the mill be of medium size or small, the adoption of standards must be studied for their general use, the work involved in maintaining proper records and the expense. Small mills with less than 100 looms may not require a standard cost system, some may purchase yarn and fabricate it into cloth and do not have several processes. Where the textile mill produces its own yarn, its problems are multiplied. There should be a continuous flow, and this requires a well balanced mill. Stoppages and bottle-necks increase costs, and the setting of standards may help to solve these problems.

The work involved in the maintenance of standards depends to a large extent on the refinements. More statistical information requires more work and more expense. For example, take the item "sales" on the general books. This item may be distributed in many different ways both as to quantity, amount, salesmen, geographical location, etc. Similar refinement may be applied to standard costs. The stock of machine parts and supplies may be on

a perpetual inventory basis, where requisitions are required, or the consumption of such items in total may be treated as an overhead item. There are many ways to "cut corners", but labor is a very important item and involves the largest number of calculations.

Direct Labor Cost Standards

The labor standard provides for the wages by departments and by operations within the department; also, the number of workers per operation, per shift. Some wages (such as overseer and sweeper) are allocated between operations in the department. If labor developed is based on a 40-hour unit and the mill runs 24 hours in 3 shifts, the unit is still 40 hours. There may not be the same number of men on each shift; therefore, the number of men on all shifts multiplied by the rate for 40 hours equals the amount allowable for the operation. That would apply to day work, but in the calculation of mill labor, the piece work is handled separately. Operations where piece work usually occur are in the slubber and spinning rooms.

In the slubber room, the slubber tender's rate would be the number of operators multiplied by their rate, and divided by the number of pounds per frame hank, then the result multiplied by the subsequent waste. (The number of pounds per frame hank equals average spindles per frame, divided by the number of hank roving).

Example: If there are 11 frames with a total of 1,096 spindles, the average number of spindles per frame is 99.63—using 1.05 hank roving, the pounds per frame hank would be:

$$\frac{99.63}{1.05} = 95$$

If the operator receives \$.35 per hank then:

\$.35 ÷ 95 = \$.003684 x 1.05 = \$.003868,

the price rate for slubber tenders.

To get the cost per pound, take the hank roving and multiply it by the slubber efficiency which is considered to be 85%; then divide this into the price rate as:

1.05 x .85 = .8925

\$.003868 ÷ .8925 = \$.00433 cost per pound

In the spinning department, the spinner's piece rate is derived by dividing the average rate per side by the product of average spindles per side multiplied by the actual pounds per 40 hours in cloth.

Example: If the average number of spindles per side is 128 with the actual pounds per 40 hours in cloth of 2.3 then:

128 x 2.3 = 294.4 (pounds per side in 40 hrs.)

If the rate per side is set at \$2.93 then:

\$2.93 ÷ 294.4 = \$.00995,

the spinner's cost per pound.

Next in the spinning department is the doffer's piece rate per pound, which is determined by dividing the doffer's rate per hour by the product of the number of bobbins each doffer lifts per hour multiplied by the amount of yarn on the bobbin, then applying the subsequent waste factor:

Example: If the doffer lifts 775 bobbins in an hour and each has .25# yarn and his rate is \$.83 then:

775 x .25 = 193.75 pounds per hour

\$.83 ÷ 193.75 = \$.00428 x subsequent waste factor

is the doffer's cost per pound.

A combined cost through spinning is determined for each number of yarn spun. After the yarn is spun, there are warping, slashing, drawing-in and tying-in operations, which also require calculations.

For weaving, a detailed Fabric Cost Sheet is prepared for each type of cloth on each type of loom. On it is shown the construction and the code name and the type of loom used. A separate sheet must be made for each type of loom, the speed of the loom and the loom production, as set by the plant manager. By the use of a simple formula the production of the loom may be computed:

$$\text{Yards per hour} = \frac{\text{picks per minute x 60 x \% of production}}{\text{picks per inch x 36}}$$

The warp and filling used in the material would be calculated as follows:

$$\text{No. of lbs. of warp yarn per yard} = \frac{\text{No. of ends x 110 (regain in warp)}}{\text{Yarn No. x 840 (yards in a hank)}}$$

$$\text{No. of lbs. of filling yarn per yard} = \frac{\text{Reed width x 40 (picks per inch)}}{\text{Yarn No. x 840 (yards in a hank)}}$$

The two types of yarn, as above, added together would give the total weight of yarn in the cloth. The difference in the finished weight of the cloth and the total weight of the yarn would represent the amount of the starch which was added.

Battery hands and weavers are on piece rate. The weaver's cost is determined by multiplying their rates by 36 and then by the number of picks in the cloth and then by the subsequent waste factor. The battery hand cost is derived by dividing the wages per week by the number of batteries filled on each type of cloth, dividing the result by the number of yards produced by the loom in 40 hours, then multiplying the result by the subsequent waste. Following the weaving there are brushing and shearing, folding, grading, pressing, baling and inspecting operations, the unit cost of which must be computed.

The standard is the manufacturing cost per unit. Raw material is added later. The cotton content would be the quantity of cotton required to produce a pound of cloth multiplied by the unit price per pound, less the value of the waste which would be produced from such quantity of cotton. Losses through waste at various stages of the process are known, and the accumulation of the departmental waste factors should be very close to the total weight of the waste produced during the year, namely, 15%.

Departmental Overhead Standards

Departmental overhead is more often estimated in total than computed. After the initial task of compiling the statistics for the bases for the distribution of overhead has been completed, the actual computation is a routine job. It is true that some of the amounts distributed are estimated, but such estimates can be reasonably close to actual. Many mills provide for a two-weeks vacation with pay for the mill workers. The mill is closed for two weeks, except for the shop and maintenance crew; and overhead in this case is distributed over 50 weeks. There are various bases for the distribution of overhead and we are not particularly concerned with them at this time. The point is that standard costs can be developed and maintained for a cotton textile mill of this type at little expense.

Uses and Advantages of Standard Costs

Standards can be used as a basis for estimating costs in advance and as a control on departmental costs. Labor costs allowable to each department can be compared with actual wages paid, and variations can be localized. Variations between actual unit costs and standards may be attributable to extra help, work stoppage, overtime, or production. Management may be aware of existing conditions but does it know how much is lost without the aid of a standard cost?

There is in operation in many mills a payroll control for mill labor by comparison of actual wages with standards. Computing costs of goods sold for interim reports based on standards is not uncommon and the results shown by such interim reports are compared with actual results at the end of the fiscal year or at the end of a shorter period, whenever the books are closed. Standards for production facilitate the scheduling of orders to be manufactured and the determination of excessive stoppages, and inefficiency.

Small and medium-sized textile companies may be reluctant to incur the expense of maintaining a cost system which requires requisitions for small parts and supplies and control of indirect materials, voluminous records, extensive distributions, various allocations, and the like. Such companies should install a standard cost system for it provides the means for the control they should have, and the expense is negligible when compared with the advantages derived.

Why Depreciation Reserve Should Not Be Deducted from Utility Plant Account

By Bernard S. Rodey, Jr., C.P.A.

The Committee on Accounts and Statistics of the National Association of Railroad and Utilities Commissioners has, on several previous occasions, recommended to the National Association of Railroad and Utilities Commissioners that the Reserve for Depreciation be included in the asset account section of the balance sheet as a deduction from Utility Plant. This recommendation has on each such occasion failed of adoption or to receive the approval of the Association. It is again included in the tentative draft of the proposed system of accounts dated November 1, 1950. It is also proposed to change the title of the account *Reserve for Depreciation* of Utility Plant to *Provision for Accrued Depreciation* of Utility Plant.

The problem of deducting the reserve for depreciation from the cost of plant assets and its serious implications involve consideration of the following other proposed changes:

(1) To change the definition of the term depreciation from the present *"loss in service value"* to *"decline in service value"*, with service value of property defined as *"consisting of its years of service or output during its service life."*

(2) To require that the charge for depreciation shall be computed in accordance with the straight-line method applied on a group plan, with no provision for use of any other method.

When the proposal for "net plant" is considered together with the proposed changes in the definition of depreciation, in the title of the depreciation reserve account, and in the requirement for the exclusive adoption of the straight-line method for charging depreciation, then the full implications of what is being attempted emerge quite clearly.

The "net plant" form of balance sheet has been advocated upon the grounds that it is a mere matter of form, and a time honored practice in industrial accounting. It has been urged that the regulated electric and gas utility industries should conform to the practices adopted by non-regulated industries and the reasons given are: that deductibility has become an accepted accounting convention; that it simplifies the work of the statistician and the security analyst; and, that no damaging consequences result therefrom.

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This paper is based upon an Edison Electric Institute and American Gas Association committee report stating the position of both the electric and gas industries in respect thereto, the author having been the chairman of the joint sub-committee which drafted the original report. The views herein expresed by the author do not necessarily represent the position of the Society on this subject.

The deduction of the reserve from plant assets is an industrial accounting custom which is unsound and incorrect in principle and, if used by regulated industries, would constitute a strong influence towards the confiscation of utility property.

The practice of deducting the depreciation reserve from plant account developed in non-regulated industries, when accountants were very much concerned with current asset position and with realizable values of assets in event of the termination of the enterprise. There was not sufficient emphasis placed upon the fact that the balance sheet represented a statement of financial position on a "going concern" basis. It was not fully appreciated that while the charge for depreciation represented allocations of cost over the periods of plant use, the depreciation reserve was represented by funds (depreciation money) which the "going concern" enterprise had recovered from its customers and was using to best advantage in the business but for which it was accountable to its investors until such time as plant assets must be replaced through actual retirement.

That this truism has not been recognized generally in current balance sheets of non-regulated enterprises is a reflection on modern accounting standards. Pursuant to accounting convention, the balances of all accountability items should be shown on the liability side of the balance sheet. However, the continuation of the practice of deducting the depreciation reserve from plant assets in non-regulated industries is certainly no authority or reason for its extension to regulated utility industries.

In electric and gas utilities, the dollar balance in the plant asset account or "original cost" symbolizes generating plants, gas manufacturing units, substations, holder stations, transmission and distribution systems, and the like. Frequently, these facilities are described as the tools of the enterprise. When the depreciation reserve is deducted from the plant account balance, the net figure merely shows the result of mixing two accounts having unrelated content. It fails to disclose that the depreciation reserve generally represents a measure of an increased investment in plant and instead causes the "net plant" account to be misconstrued as a measure of a diminished volume of tools and facilities employed in the business. This constitutes substantial error and gross misrepresentation of material fact. The balance in the plant account should represent the total cost of plant assets then in service, not that cost diminished by the depreciation reserve. The accepted accounting procedure for recording depreciation which attempts to assure proper distribution of costs should not be permitted to obscure the significant figure of actual cost of plant assets in service.

It is necessary, in order fully to understand the meaning of the current proposals, to examine carefully all of the provisions relating to depreciation which give full import and expression to what may easily constitute a very serious financial blow to these utility industries. Detailed objections, discussions, and conclusions, in support of what has been stated, follow.

Implications in the N. A. R. U. C. Committee Provisions Relating to Depreciation and Reserve for Depreciation

The electric and gas utilities believe that the implications and the real meaning of the provisions relating to depreciation, as now proposed by the Committee on Statistics and Accounts in the N.A.R.U.C. system of accounts, are as follows:

(1) That depreciation of utility plant, according to proposed definition, represents decline in service value or service life.

(2) That the accounting charge for depreciation, based upon the requirement of the straight-line method and the proposed definition of depreciation, represents periodic declines in value proceeding uniformly during the life of the plant assets.

(3) That the proposed change in title of the reserve for depreciation account to "Provision for Accrued Depreciation" will be interpreted as representing the measurement of all such declines in service value of plant assets since acquisition thereof and is the equivalent of "depreciation reserve requirement" computed in accordance with the straight-line method.

(4) That since the balance in the "Provision for Accrued Depreciation" (following the above fallacious reasoning) represents the total declines in service value which have accumulated by reason of the passage of time, then—

(a) the accumulated reserve constitutes an offset or deduction from the plant account, and

(b) past accrued depreciation (calculated on the straight-line basis), not previously provided for, is to be increased by charges to "Special Income Charges." This adjustment of the depreciation reserve constitutes retroactive accounting and violates the principle against impeaching past accounting results.

The electric and gas utilities are convinced that the N.A.R.U.C. Committee's proposed provisions relating to depreciation and the depreciation reserve represent incorrect and inconsistent interpretations of the functions and results of depreciation accounting.

Objections to the Accounting Practice of Deducting the Depreciation Reserve from Plant Assets in Non-regulated Industries

The propriety of deducting the depreciation reserve from plant assets must be considered, both as to non-regulated and as to regulated industries. The present industrial practice had its origin in the now obsolete direct write-down methods. Early in the history of corporate accounting, when the knowledge and understanding of systematic and consistent recording of depreciation as a cost were very meager, managements in "good earning years" wrote down directly the cost of their fixed assets by credits thereto and charges direct to "Profit and Loss." As a result of this practice, the plant account itself was the net result of such bookkeeping. In "lean years," the former practice did not appear to require any recognition of "depreciation" as then understood. With this earlier accounting practice, the recording of retirements when property was actually replaced, sold, torn down, or abandoned also was not required. It was, however, gradually recognized that such accounting was erroneous and misleading and without factual background or consistency. It produced neither cost nor value. It was, perhaps, a more or less conscious attempt at earnings equalization or disguise.

Later, more enlightened depreciation accounting established the credit account—Depreciation Reserve—the balance of which is the result of periodic journal entries, which systematically estimate appropriate charges to depreciation expense and concurrent credits to depreciation reserve, together with any charges to depreciation reserve and credits to plant accounts for retirements of property.

These journal entry transactions are designed to accomplish two primary objectives: first, to include with other expenses an allocation (by estimate) of cost of property used in the production of income; and second, to withhold funds within the business to maintain the stockholders' investment until property has actually been replaced. The act of showing such balances as a deduction from the Plant Account on the asset side of the balance sheet is thus a carry-over from the obsolete accounting practice of making direct credits to the plant accounts, a practice which was abandoned as misleading and erroneous.

The proportion of the plant accounts to total assets in non-regulated industry until recently was usually not significant, and the statement of plant assets less depreciation reserve had

perhaps no important effect upon the financial position of the enterprise, in that it did not prejudice the value of its properties or its prospective earning capacity.

Nevertheless, the practice of deducting such depreciation reserve from plant assets has resulted in incorrect statements of the total amount of assets devoted to the conduct of the business and of an important accumulated source of funds invested in the business. It has in many cases resulted in the non-disclosure of either the reserve or the true plant costs in attempts to secure more simplified reports. More seriously, it has resulted in the drawing of unwarranted conclusions as to the amounts of profit and percentages of profits relating to the total assets invested in the business. This misrepresentation has extended to the ordinary investor who interprets the depreciation reserve as a diminution in value, without fully understanding that the figure for plant assets less reserve for depreciation, whether described as "net plant" or shown with no caption, merely represents, if anything, the unallocated or undistributed cost of fixed assets not yet charged to expense.

The proposal for the extension of the practice of deducting depreciation reserves from plant assets is particularly inappropriate at this time when serious criticism is being directed against the accounting convention for stating plant assets at cost. In view of the substantial reduction in the value of the dollar, many accountants realize that the statement of plant assets in terms of monetary units, which are worth, in effect, only half of their former value, may represent a serious defect in current accounting practice. In the face of this dilemma, the implication that such "net plant" bears any semblance or relationship to value, further aggravates the inaccuracies in statements of plant assets.

As inaccurate as the overemphasis on "net plant" balance may be industrially, it is still much worse and really harmful to the regulated industries.

Objections to Deducting the Depreciation Reserve from Plant Assets in Regulated Electric and Gas Utility Industries

As applied to regulated utility industries, the deduction of the depreciation reserve from plant assets is of far greater significance than for non-regulated industries, and the electric and gas industries strenuously object to this proposed provision for the following reasons:

(1) Constitutes a misrepresentation of material facts and an admission against interest

The N.A.R.U.C. Committees would require that the reserve be deducted from plant accounts in reports submitted to regulatory and other public authorities. Financial officers of regulated companies should not be required to assume responsibility for sworn statements or statements which contain a gross misrepresentation of material facts and which will be considered as an admission adverse to the interest of the electric and gas utility industries.

(2) Discards 50 year electric and gas utility accounting convention

The proposal discards, without sound reason, a consistent and continuing accounting convention used in the electric and gas business for the past 50 years. In regulated public utilities, costs of plant and properties represent the largest proportion of the total assets and the single most important factor in determining earning capacity. Because of the high proportion of plant assets to total assets and because of the relatively long life of plant assets, the accumulated depreciation reserve necessarily amounts to a very substantial figure. To deduct the depreciation reserve from plant assets will lead to the erroneous interpretation that the resulting figure represents the value of utility plant. Depreciation accounting

on a cost basis does not, except by chance, produce a value or component of value. The accounting convention for stating plant assets at cost should not be undermined by deducting therefrom amounts which relate only to the expense charges for the ultimate retirement of plant.

(3) Deduction is erroneous because existing reserves are not the result of consistent charges and credits

Different concepts of accounting and rate regulation over the years have produced reserves of various content. Existing depreciation reserves may represent a product of past charges entirely to operating expenses or partly to operating expenses and partly to income deductions; or they may reflect transfers from or to capital or surplus accounts; or they may include other credits such as accelerated amortization, or tax savings relating thereto, additional depreciation for plant assets constructed on leased premises, gains or losses from sales of land and nondepreciable property, etc. The depreciation reserves may also include charges for depreciation, which were provided for during periods of insufficient return, or may include excessive provisions for depreciation. The figure, therefore, for plant assets less reserves does not reflect an accurate statement of a significant financial fact.

(4) Proposal is an attempt to set up standards for State legislation and Commission regulation of rates which would be confiscatory

The electric and gas utilities believe that deducting the reserve for depreciation from plant assets will give wider acceptance to the use of *plant "original cost"* less *depreciation reserve* or *depreciation reserve requirement* as a standard formula for rate making. It is the industries' contention that cost less reserve must not be used indiscriminately for determining the rate base.

The entire amount of the depreciation reserve is almost never invested in plant assets and in many cases a substantial portion of the reserve may be used to supply working capital in excess of that amount allowed in the rate base. To deduct these portions of the reserve would result in serious inequity to the utility. Even if the assets have been so invested, the credit due to the customers' interest, in respect of the funds represented by the depreciation reserve, should be computed at a rate lower than the allowable fair rate of return, since the entire risk must be borne by the investors.

Where full deduction of the reserve is made in the calculation of the rate base, the net effect is that the customer is being permitted to buy back, piecemeal, part of the property which the utility must continue to operate without compensation. This is not in accord with the real nature of the transaction. Title to the property remains at all times with the utility and does not pass to the customer; what the customer pays for is service, not property. The utility should be operated for the benefit of customers, investors, and employees. If financial fair play is to be accorded to all three groups, then the utility should not be required to manage property without compensation.

The depreciation reserve may include amounts which were charged against income when the utility was not earning a fair rate of return, and to such extent, the assets represented by the depreciation reserve constitute a source of funds contributed by stockholders rather than by consumers. When the depreciation charges have exceeded the amounts allowed in fixing rates, the portion of the reserve represented by the excess arises from earned surplus. The depreciation reserve may also reflect transfers arising out of capital transactions or credits arising from accelerated amortization, all in no manner related to charges to consumers.

That the deduction of the depreciation reserve from plant assets in accounting reports will have widespread influence on rate base determinations is clearly evident. Practically all state

commissions prescribe the N.A.R.U.C. or F.P.C. Uniform Systems of Accounts for electric and gas utilities. This means that throughout the United States practically all utility plant accounts are stated at "original cost." On the other hand, according to a 1948 Federal Power Commission Report, in only eight states is original cost the most important factor in rate-base determinations; and of these only a few at this time unqualifiedly deduct the book reserve or reserve requirement to determine the rate base.

The adoption of plant assets less depreciation reserve as a ready rate base is demonstrably unfair without full consideration of all significant facts. This constitutes the chief reason for the continued *insistence* for including the depreciation reserve account in the asset section of the balance sheet accounts.

(5) Deduction of reserve will adversely affect investment standing of utilities

The deduction of reserve for depreciation from plant assets will have an adverse effect on the investment standing of utilities. Investment groups will receive the impression that regulatory bodies have come to agreement to adopt arbitrarily the "net plant" basis for rate determination. Investors will view this arbitrary requirement as limiting earnings within the confines of a rigid formula.

(6) "Depreciation money" is not return of capital to investors

The amounts represented by the depreciation reserve do not constitute capital which has been returned or is returnable to the investors. Utilities are under legal obligation to replace plant assets and to construct plant additions in order to satisfy the service requirements of their customers. The funds represented by the depreciation reserve balance cannot be distributed to investors but must be used for the replacement of plant assets. The depreciation reserve must, therefore, be regarded as an advance payment by consumers (provided an adequate return has been earned) for plant assets, and when the funds represented by such reserve are invested in additional plant assets, the management has in effect made a borrowing of such funds, pending replacement of existing plant assets.

Depreciation accounting must be viewed not only as an allocation of the cost of plant assets against the income but also as representing a source of funds held until existing plant assets are replaced. While it has been recognized that the most advantageous use of these funds can be obtained by investing in new or additional plant assets, it does not alter the basic fact that the reserve for depreciation, nevertheless, constitutes a source of funds and, as such, represents additional assets invested, instead of reflecting reductions in assets employed.

Objections to the Proposed Provisions for: (1) Changing Title of Reserve for Depreciation Account, and (2) Retroactive Accounting for Depreciation

The following analysis is submitted in support of the objections to the proposed changes in respect of the depreciation reserve both as to title and account arrangement:

(1) Change in Title of Reserve for Depreciation to Provision for Accrued Depreciation

Having defined depreciation of utility plant as representing decline in service value or decline in service life and having adopted the theory that depreciation proceeds uniformly on a straight-line basis, the N.A.R.U.C. Committee proposes that the present title for accumulated depreciation be changed from *Reserve for Depreciation* to *Provision for Accrued Depreciation.*

The word "accrued" does not properly indicate that depreciation is a process of allocation of plant assets in a systematic and rational manner. The

combination of the two words "accrued depreciation" is even more misleading because it has been used to mean different things. In the accounting sense, it means amounts entered or recorded in the books of account as periodic distributions of cost. In the engineering sense, the term has been used to mean value, which is estimated to have been actually lost. The N.A.R.U.C. Committee on Depreciation has in its 1944 report referred to accrued depreciation as "the amount of service life or capacity deemed to have been exhausted at any particular time as estimated by the consistent application of the age-life basis." In the same report the Committee also referred to the "depreciation reserve requirement" and "accrued depreciation" as being essentially the same thing and stated that the depreciation reserve requirement properly computed is the best practical measure of actual depreciation.

The American Institute of Accountants in considering change in the title "Reserve for Depreciation" arrived at no precise conclusion other than to advise that the term "reserve" be replaced by one which indicated the measurement process of allocation of cost over the life of the asset. The Securities and Exchange Commission in its latest Regulation S-X, issued in December, 1950, retains the title, "Reserve for Depreciation."

The electric and gas utility industries believe therefore that no change should be made in the present account title until a more descriptive title has been generally adopted if this be possible. The accounting prescribed for regulated industries should not initiate new and untried accounting terminology. However, if there is to be a change in terminology, it should contribute to clearer thinking and not increased confusion. The word *depreciation* itself has no proper place in an accounting system that is wedded to the cost convention.

(2) Implication of Retroactive Accounting for Depreciation

No consideration has been given in the proposed system of accounts for the change to the required straight-line method, other than that "provision for past accrued depreciation not provided for" is included as one of the items in Account 461, Special Income Charges.

It must be recognized that many utilities accounted for depreciation for many years in accordance with theories then widely accepted by regulatory agencies, as well as utility managements, which required minimum depreciation charges and reserves and that such retroactive adjustments may involve very substantial amounts. Even where the reserves have been increased substantially, there is the question always, at whose cost? And even where this may be clear, complete deductibility confiscates a substantial part of the investor's equity, and where the sinking-fund method for computing depreciation is permitted or prescribed by state regulatory authorities, in some jurisdictions, the retroactive adjustments may unfairly affect the utilities.

To effect the changes retroactively for past charges for depreciation is incorrect unless charges are effected retroactively in all other accounts, and this is an obvious impossibility. The investor interest is the only one that can possibly be affected by retroactive accounting for depreciation. Surely, this cannot be considered fair. Retroactive adjustment of depreciation accounting should not be required without permitting the upward adjustment of capital assets (now stated at so-called "original cost") to conform to the present concepts of cost determination and property units and present concepts for distinguishing between cost of utility plant and operating charges.

Conclusions

The electric and gas utilities believe that the present title of reserve for

depreciation should be retained and that the title of the account should not imply in any manner that the balance represents something other than its true content. The expression "accrued depreciation" in a title for reserve for depreciation is inappropriate, since it is not sufficiently distinguished from "depreciation reserve requirement," which is ordinarily used to mean the amount that ought to be accumulated in the reserve at any given time on the basis of a given or required method of systematic allocation of cost. The accounting terminology for regulated companies should follow accepted practice, and no changes should be made until more descriptive titles have been fully accepted.

The electric and gas utilities also believe that the reserve for depreciation account should be included with all other credit balance sheet accounts consistent with present practice. The issues involved in respect to balance sheet presentation of plant accounts and reserve for depreciation for public utilities must remain clear. The fact that deductibility of depreciation has become acceptable accounting practice in non-regulated industries is no reason for this practice to be adopted by regulated industries. The convention for showing the reserve on the credit side of the balance sheet of regulated utilities is of long standing, and no new developments have taken place which require the change in account arrangement or balance sheet presentation. The arbitrary requirement for deducting the reserve for depreciation can only be interpreted as an attempt by the Committee on Statistics and Accounts to establish through accounting a standard formula for rate determination which the courts and the legislatures have refused to adopt because of the realization of the inaccuracy and unfairness of the end result.

Deduction of the depreciation reserve from the "original cost" of plant results in a monetary reduction in assets, when in fact the reserve actually measures, in most instances, an additional investment in plant and an increase in the volume of physical assets employed in the business. Regulated electric and gas utility industries should not be required to submit statements that would contain such misrepresentation of material facts, which would be construed as serious admissions against interest and which would be a strong influence toward the confiscation of their property. Existing depreciation reserves are not the result of the same types of charges and credit transactions in various companies or over a period of time, and the net figure, after deducting the reserve, would represent a different result for each company, but in any event, would not reflect an accurate statement of any significant fact useful for financial or any other purpose.

The presentation of the reserve on the credit side of the balance sheet conforms to sound accounting principles. No good reason has been offered why regulated industries, where the plant account is the most important factor in determining its permitted earnings, should follow the practice of deductibility simply because it has been heretofore accepted in non-regulated industries and where it does not have the same significance. Questionable as is the practice to deduct the reserve in the case of non-regulated enterprises, it has a far greater significance to regulated utilities, and its adoption will lead to improper conclusions and result in unfair losses to investors. Regulatory authorities should not prescribe accounting provisions which will unjustly, seriously, and needlessly, affect the electric and gas utility industries.

The 112th New York Certified Public Accountant Examination

NOVEMBER 7, 8 AND 9, 1951

THEORY OF ACCOUNTS

Friday, November 9, 1951—1.30 to 5 p. m., only

This paper is intended to test the extent of your knowledge of accounting theory and your ability to apply the knowledge you have acquired. Due weight will be given to the arguments presented to support your answer to each question, even though the examiners may not agree with your conclusions.

Answer eight of the following ten questions.

1 In selecting a basis for pricing inventories, accountants have as one important objective the proper determination of income by matching appropriate cost against revenue. Does the pricing of inventories at "cost or market, whichever is lower" conflict with that objective? Discuss fully, including consideration of the effect of the "cost or market" rule on the usefulness of income statements and balance sheets. [12½]

2 Receivables may be classified and identified on the balance sheet under a number of different titles or captions. Give *eight* captions for receivables, all of which might appear on balance sheets. Give reasons for using a number of sub-classifications for receivables on a balance sheet instead of using a single caption for all receivables. [12½]

3 It has been proposed that the "reserves" section on the liability side of the balance sheet be eliminated and that all such reserves be classified either as liabilities or as part of the stockholders' equity. Give the arguments for and against this proposal. [12½]

4 The G Corporation carries insurance considerably in excess of the book value of its fixed assets because of the increased cost of replacement. One of its buildings was destroyed by fire and the company collected an amount approximately three times the carrying value of the asset. It then used the entire proceeds from the insurance to construct a similar building. In your examination of the accounts you find that the company accountant, following instructions from the company president, has charged annual depreciation on the new building at the same amount as previously charged on the old building, although depreciation computed on the cost of the new building would be almost double the previous depreciation. The president's argument is that the company must be consistent. Give a complete discussion of the propriety or impropriety of the procedure followed by the company. Do not consider income tax effects. [12½]

5 A manufacturing concern follows the practice of charging the cost of direct materials and direct labor to work in process but charges off all indirect costs (factory overhead) directly to profit and loss. State the effects of this procedure on the concern's financial statements and comment on the acceptability of the procedure for use in preparing statements. [12½]

6 [12½]

a Explain why footnotes to financial statements are sometimes necessary.

b Give *four* different examples of information which might be disclosed in footnotes to financial statements.

c Give *four* different examples of information which might be contained in an auditor's long-form report but which probably would not appear in the auditor's opinion or in the financial statements or footnotes.

7 [12½]

An established business is to be sold as a unit. You are engaged to assist in determining the presence or absence of goodwill.

a Define goodwill as related to this type of transaction.

b Describe *two* methods which you consider useful for a purchaser of a business in computing the amount of goodwill of a business.

c State the weaknesses and limitations of the two methods which you described in *b* above.

8 [12½]

The X Company has a fiscal year ending on March 31st. The controller is in the process of preparing the monthly statement of financial condition as of October 31, 1951, and requests your advice in the determination of the correct liability for the federal income and excess-profits taxes at that date.

Net taxable income for the seven months ended October 31, 1951, is reported to be approximately $98,000. The company is not at all certain as to the earnings to be anticipated for the remaining five months of its fiscal year. The sales manager states that he believes the same rate of profit can be maintained as has been obtained in the seven months ended on October 31st. However, the controller is not optimistic, even suggesting that a loss will occur if needed materials are not obtained soon. The president recalls that only $30,000 was earned in the five months of the previous year between October 31, 1950, and March 31, 1951. He believes enough business can be completed to obtain that amount of earnings in the five months ending March 31, 1952. He is particularly anxious to have a correct determination of liability for these taxes at October 31, 1951, because he has arranged to sell part of his capital stock of the company at its book value on that date.

The controller informs you that the earnings of the current fiscal year will be subject to excess-profits tax to the extent that they exceed approximately $75,000 according to his computation of the excess-profits tax credit, which you find to be correct. Adequate provision has been made for taxes of prior years and you are to be concerned only with the interim period of the current year.

You are to prepare a brief memorandum for submission to the controller discussing the problems involved in determining the proper accrual of these federal taxes at October 31, 1951. Describe briefly the methods by which such accrual could be calculated and indicate the method which you consider preferable in the circumstances, giving reasons for your choice. Do not make, or describe in detail, the actual computations.

9 [12½]

In accounting for a testamentary trust, there is a problem of separating the items that should be charged against principal from the items that should be charged against income. You are to state whether *each* of the following items would be charged to principal or to income, assuming that the most general rule is to be followed. Give any explanation you consider necessary in connection with your answer.

(1) Federal estate taxes paid.
(2) Interest paid on mortgage on real estate.
(3) Depreciation of real estate.
(4) Legal fees for collection of rent.
(5) Special assessment tax levied on real estate for street improvement.
(6) Amortization of premium on bonds which had been purchased by the testator.
(7) Loss on sale of trust investments.
(8) Taxes on vacant city lots.

10 [12½]

a A stockholder who owns some stock in a listed corporation is concerned because she receives such small dividends. She has reviewed the last stockholder's report and has concluded there is ample cash available for much larger dividends. In addition to cash in banks, the corporation's balance sheet shows the following items which she believes represent cash funds:

(1) a large "Paid-in surplus"
(2) plenty of "Undivided profits"
(3) a large "Reserve for general contingencies"
(4) a substantial "Reserve for depreciation"

In simple, non-technical language, explain the nature of the items which the stockholder has confused with cash.

b The stockholder is further perturbed because the corporation's most recent balance sheet shows goodwill at only $500,000, whereas a year before it had been shown at $1,000,000. She believes that a corporation which is losing goodwill so rapidly must be poorly managed.

In simple, non-technical language, write an explanation which should clear up the stockholder's misunderstanding.

COMMERCIAL LAW

Friday, November 9, 1951—9 a. m. to 12.30 p. m., only

Reasons must be stated for each answer except for objective type questions; no credit will be given for an answer unsupported by a statement of reasons. Whenever practicable, give the answer first and then state reasons. Answers will be graded according to the candidate's evident knowledge of the legal principles involved in the question rather than on his conclusions. Answers to questions involving negotiable instruments, partnerships and sales should be based on the provisions of the pertinent Uniform Law.

Group I—Answer all questions in this group.

1 [10]

a Define or explain the following: (1) future goods, (2) fungible goods, (3) good faith purchaser.

b Explain fully the effect on a sale of specific goods which at the time the agreement was made have been (1) wholly destroyed, (2) partially destroyed.

c Under what circumstances may the unpaid seller (1) maintain a lien on the goods sold, (2) stop the goods in transit, (3) resell the goods?

2 [10]

A, B and C were partners conducting an accounting firm. Capital contributions were $4,000, $3,000, and $3,000 by A, B and C, respectively. Answer the following questions, using Uniform Partnership Act rules.

a At the end of the first year the firm had a profit of $15,000. How much should A receive, nothing being said in the partnership articles as to ratio of profit sharing? Why?

b B, without the knowledge or consent of A and C, contracted in the firm name to buy a set of tax reports from X. Could the firm be held for breach of contract if A and C refused to accept the books because the firm articles gave A the sole right to purchase for the firm? Explain.

c The partnership articles provided that the firm was to continue for five years. C withdrew at the end of the second year.

(1) What right is denied him in computing his interest to be paid him by the firm?

(2) What liability does he assume to his partners?

3 [10]

M drew a check for $100 on his account in X Bank. He delivered it to P in payment for goods purchased from P. P took the check to X Bank and had it certified. P then sold and endorsed the check in blank to H, a holder in due course. H presented the check properly to X Bank. The bank was insolvent and refused to cash the check. H gave proper notice of dishonor to M and P. Give your reasons to support your answer to *each* of the following questions.

a Can H recover $100 on the check from M?

b Can H hold P for the amount of the check?

c Has H a valid claim against the insolvent bank?

4 [10]

a What implied duties does an agent owe to his principal?

b What implied duties does a principal owe to his agent?

c In the law of agency, what is meant by (1) an agency coupled with an interest, (2) independent contractor, (3) ratification, (4) ostensible agency, (5) election?

5 [10]

a Explain the difference between a surety and a guarantor.

b May a valid surety contract be entered into by

(1) a corporation? Explain.

(2) a partnership? Explain.

c If a creditor should refuse to accept a valid tender of payment of his debt, what would be the effect as to (1) the debtor, (2) a surety?

d (1) If there are three sureties for the same debt, and also collateral security pledged to pay that debt, may the creditor in case of default by the debtor proceed against one surety for the entire debt? Explain.

(2) May he take any action against the surety or sureties without first liquidating the collateral?

Group II—Answer any five questions in this group.

6 [10]

a Sam, an infant, on his fourteenth birthday purchased a bicycle from Wells, an adult, for $55, payable $10 down and the balance to be paid at the rate of $5 per month. After making two monthly payments, Sam made no further payments. Wells made no demand for further payments and made no demand for the return of the bicycle. Six months after Sam became of age he sold the bicycle to Hall. Shortly thereafter Wells sued Sam to recover the unpaid balance of the purchase price of the bicycle. Sam set up as a defense (1) infancy, and (2) the statute of limitations. The statute of limitations of the state reads as follows: "The following actions shall be commenced within five (5) years after the cause of action has accrued, and not afterwards: First. On accounts and contracts oral or in writing." Are either of the defenses good? Explain.

b Assume that instead of selling the bicycle after he became of age Sam had promised in writing to pay the balance on a day certain and, on Sam's failure to pay, Wells had sued and Sam had set up the same defenses as stated in part *a*. Would the defenses be good? Explain.

7 [10]

Define briefly the following terms as they are used in the law of corporations: (*a*) cumulative preferred stock, (*b*) participating preferred stock, (*c*) no-par stock, (*d*) preemptive right of a stockholder, (*e*) cumulative voting.

8 [10]

H was a holder in due course of a negotiable instrument made by M which matured on June 1, 1951. H presented the instrument on June 1 to M who refused to pay as he was insolvent. A, B and C, in that order, were the endorsers on the instrument. Assume all parties are in the same town. Give reasons for your answers to *each* of the following questions:

a If H should call C on the telephone on June 2 and tell him of the dishonor, could H hold C for payment of the instrument?

b If C should call B on the telephone on June 3 and inform him of the dishonor, could C hold B for payment of the instrument, assuming C had paid H?

c If B should mail a letter to A on June 3 in which he told A of the dishonor, which letter was received a week later, could B hold A for payment of the instrument, assuming B had paid C?

d Would you allow H to recover the face of the instrument from either B or A if H had called C and C had called B and B had sent a letter to A in accordance with the statements in *a*, *b*, and *c* above?

9 [10]

a Name *four* reasons or circumstances, any one of which may be sufficient to bar a bankrupt debtor from obtaining his discharge in bankruptcy.

b Name *four* types of claims which are not discharged by a discharge in bankruptcy.

c Under what conditions may a preferential transfer be avoided by the trustee in a bankruptcy proceeding?

10 [10]

Green entered into an option agreement to purchase certain tracts of land. Before the expiration of the option period, Green exercised the right of election granted therein by giving the seller written notice that he would purchase the property. Subsequently, and before the expiration of the option period, Green entered into an oral agreement

with R whereby Green agreed to sell and R agreed to purchase from Green all of Green's interest in and to said option agreement. R further orally agreed

(1) to pay the consideration fixed by the option and to perform all of the terms and conditions of said option agreement

(2) to form a corporation which was to take title to said property

(3) to cause said corporation to issue 25% of its capital stock to Green and further promised to pay to Green the par value of the stock at any time the market value of said stock should be less than 50% of the par value of the stock

(4) to cause the corporation to employ Green for a period of five years at a salary of $20,000

R was to retain a controlling interest in the capital stock of the corporation. Green performed his obligations under the agreement but R refused to perform. Green brought suit and R set up the statute of frauds as a defense. Are the oral promises of R enforceable under the statute of frauds? Explain.

11 [10]

Write the numbers 1 through 10 on your answer sheet. Opposite each number you are to write the word "True" if the numbered statement is true or the word "False" if the statement is not true. Your grade will be based on the number of correct answers. No reasons need be given.

(1) A trust may be created either by will or during the lifetime of the settlor or creator of the trust.

(2) If the trustee named in the trust fails or refuses to serve, the trust will be terminated.

(3) A settlor of a trust can himself be the trustee if the trust is created for the benefit of a third party.

(4) A settlor can not create a trust with himself as beneficiary.

(5) If the trust instrument so provides, the settlor may revoke a trust.

(6) A constructive trust must be created in writing.

(7) A charitable trust is essentially different from a private trust in that the beneficiaries are uncertain.

(8) A trustee must keep the trust funds separate from his own funds. Under this rule, the trustee may not deposit trust funds in his own bank account even if his motive is innocent.

(9) A trustee is personally liable on contracts made by him for the benefit of the trust estate.

(10) A Court of Equity will usually terminate a trust before the purpose of the trust has been accomplished if all of the beneficiaries consent.

12 [10]

Write the numbers 1 through 10 on your answer sheet. Opposite each number you are to write the word "True" if the numbered statement is true or the word "False" if the statement is not true. Your grade will be based on the number of correct answers. No reasons need be given.

(1) A person who procures a policy of life insurance upon his own life may name as a beneficiary a person who has no insurable interest in the life of the insured.

(2) A misrepresentation does not affect the validity of insurance unless it materially affects the risk.

(3) A obtained a $20,000 policy of life insurance and named a grandson as the beneficiary, reserving the right to change the beneficiary. A later became a bankrupt and the trustee desires to obtain the cash surrender value of the policy for the benefit of creditors. The trustee may not obtain the cash surrender value of the policy.

(4) A, by substantial and intentional misrepresentations concerning his health, obtained a $50,000 policy of life insurance which contained a two-year unqualified incontestable clause. If A dies three years later and no steps had been taken to avoid the policy prior to death, the policy is enforceable.

(5) A carried a $50,000 policy of fire insurance upon a stock of merchandise described as stored in a particular warehouse. The merchandise was later moved to A's retail store where it was destroyed by fire. A may recover for the fire loss.

(6) A's business building is worth $100,000 and he carries a $40,000 policy of fire insurance on it which contains an 80% co-insurance clause. If a $60,000 fire loss occurs, A's recovery is limited to $30,000, which he may collect.

(7) A carried a $50,000 policy of fire insurance upon a building in which he conducted a business. There was a $20,000 fire loss and A was without the use of the building for three months which was reasonably valued at $4,000. A is entitled to recover $24,000 on his policy of fire insurance.

(8) A carried collision insurance on his automobile with X Company. The car was badly damaged by reason of the carelessness of T. By a valid contract A released T of liability and now seeks to recover of X Company. He should be able to recover.

(9) A borrowed $10,000 from B, and B took out a $10,000 policy of life insurance on A. A assented to the insurance. A died eighteen months later at which time he owed B only $3,500. The insurance company is liable to B for the full $10,000.

(10) O borrowed $10,000 from M and secured the loan with a mortgage on a certain building owned by O. M took out a policy of fire insurance on the building for $10,000 in which M was the only named beneficiary. A $15,000 fire loss occurred at a time when the debt had been reduced to $7,000. The insurance company must pay the full $10,000.

AUDITING

Thursday, November 8, 1951—9 a. m. to 12.30 p. m., only

Answer all questions. Credit will be allowed not only for accuracy of answer but also for technic.

1 Prepare a simple illustration of "lapping" of cash receipts, showing actual transactions and the cash book entries. [10]

2 You are making a regular annual audit of a retail furniture store which sells on an installment basis. In outline form, prepare an audit program for installment notes receivable. [12]

3 [8]

a It is your client's policy to have invoices and supporting documents accompany all checks presented for signature. The signing officer insists that the invoices and documents be marked "paid" before he will review them and sign the checks. His objective is to preclude resubmission of the same invoices and documents in support of another check. Do you believe this procedure is effective? Explain.

b You audit a small corporation which publishes fiction and other non-technical books. Sales are made by four salesmen to about 1,000 retail bookstores. Because of his familiarity with the bookstores, the sales manager has been asked to approve each order before shipment is made. In the case of delinquent accounts the sales manager decides whether or not further credit should be extended and his approval is necessary for any write-off of bad accounts. One bookkeeper and two billing clerks handle the accounting records. The other personnel are three editors and their secretaries and one production man who contracts with printers for the manufacture of the books. Shipments are made from the printers' warehouses directly to the bookstores. In what ways are you, as an auditor, affected by the internal control over credit? Explain.

4 [10]

You are the senior on an audit of a manufacturing corporation with about six hundred employees. A portion of your firm's internal control questionnaire on payroll shows the following:

a Who prepares the payroll?	Answer—payroll clerk
b Who prepares payroll checks?	Answer—payroll clerk
c Who approves the payroll?	Answer—chief accountant
d Who signs payroll checks?	Answer—assistant treasurer
e Who distributes pay checks?	Answer—department foremen
f Who authorizes pay rates?	Answer—plant superintendent
g Who reconciles payroll account?	Answer—chief accountant
h Who controls unclaimed checks?	Answer—chief accountant

What further questions should be included in the questionnaire to permit an appraisal of the effectiveness of the internal control over payroll? Explain why each of the additional questions is needed.

5 [10]

Your client has several accounts in the same bank. One of these accounts is restricted to weekly payroll disbursements and is operated on an imprest basis. The account should always reconcile to a zero balance and for this reason your client has not bothered to reconcile the account at any time during the year under review. The account does not appear in the general ledger.

In the course of your audit of the payroll account you examine all cancelled checks returned by the bank during the eight weeks following the balance-sheet date. Included among these are checks totaling $2,600 which are dated prior to the balance sheet. The paymaster also has on hand unclaimed payroll checks for $200 dated prior to the balance sheet. The bank statement shows a balance of $2,300 at the balance-sheet date.

Required: Assuming that no fraud is involved and that no errors in footing have been made, give *three* possible explanations of the situation indicated by the figures. For each explanation, give the procedures you would follow to determine if the explanation is correct.

6 [20]

As of December 31, 1951, you are conducting your firm's first audit of the S Manufacturing Corporation. Although the corporation is small, it does have a chief accountant. He has already prepared statements for the year 1951 and included therein the following analysis of surplus:

Balance, January 1, 1951	$43,507
Net income for the year	16,212
Gain on sale of equipment	146
Premium on sale of capital stock	3,200
Total credits	$63,065
Reserve for income tax on 1951 income	$ 5,000
Dividends paid	5,000
Pension payments to retired officer	2,000
Total debits	$12,000
Balance, December 31, 1951	$51,065

a Give in detail the procedures to be followed in the audit of each item in the above analysis except "Net income for the year." Your engagement does not include the preparation of the income-tax return.

b State the changes you would recommend in the presentation of these items in the financial statements. Give reasons for any changes recommended. Give the justification for not changing the items which you believe are properly presented.

7 [15]

Your client, The Pram Corporation, manufactures baby carriages as its only product. The corporation maintains perpetual inventory records in quantities and values and also takes a complete physical inventory each October 31st. You observed the physical inventory at October 31, 1950, and were satisfied with the procedures followed. From your test counts you are satisfied that the client's counts were substantially accurate.

There were differences between the client's count and the perpetual records for about 75% of the items. Before adjusting the inventory records for the larger differences, of which there were about 25, the records were checked and the items were recounted. Typical examples of adjustments for the larger differences are:

Description of Item	*Perpetual Record Before Adjustment*	*Perpetual Record After Adjustment*
Black paint (in gallons)	662	647
Cotter pins (in dozens)	2,260	2,160
Hub caps	8,592	8,708
Assembled wheels	6,901	6,883

The Pram Corporation made no further physical tests of inventories during 1950. For its year-end closing at December 31, 1950, the corporation used inventory quantities shown by the perpetual inventory records.

Prepare in outline form an audit program setting out the essential procedures to be followed in your audit of inventories as of December 31, 1950. Do not include procedures unless you believe them to be essential under the conditions as stated.

8 [5]

An auditor makes an agreement with one of his clients that the amount of his audit fee will be contingent on the number of days required to complete the engagement.

a What is the essence of the rule of professional ethics dealing with contingent fees and what are the reasons for the rule?

b Did the auditor violate the rule?

9 [10]

a Explain how an examination of insurance policies might indicate *each* of the following:

(1) the pledge of inventory as collateral on a loan

(2) the disposition of fixed assets without entry on the books of account

b In connection with a regular annual audit, what are the purposes of a review of sales returns and allowances subsequent to the closing date?

PRACTICAL ACCOUNTING — Part I

Wednesday, November 7, 1951—1.30 to 6 p.m., only

Solve all problems. Consider technic and neatness as carefully as mathematics. Answers are to be written on one side of the paper only. Working papers (but not statements) may be in pencil. All other papers are to be written in ink. The use of a slide rule is permitted.

1 [15]

The following questions relate to federal income taxes. No reasons need be given to support your answer. Your grade will be based entirely on the number of correct answers you submit.

a The following 17 items are to be considered as to whether they are essentially true or false statements. If the statement is true, enter the letter (a) on your answer sheet. If the statement is not true, enter the letter (b).

(1) X, a single man, over 65 years of age, supports a sister who is 67 years of age and who has no income. X is entitled to $2,400 in exemptions. (a) True (b) False

(2) An infant son who has $525 in gross taxable income can not be claimed by his father as a dependent. (a) True (b) False

(3) Interest on principal amount of $10,000 of U. S. Savings Bonds in the name of an individual issued prior to March 1, 1941, is excluded from gross income. (a) True (b) False

(4) Unemployment insurance benefits paid by a state do not constitute taxable income to the unemployed recipient. (a) True (b) False

(5) Monthly payments received by a wife under a decree of separate maintenance, where such decree does not provide for a fixed amount payable in installments, are not includible in the wife's gross income. (a) True (b) False

(6) The sale of municipal bonds, the interest of which is non-taxable, at a gain gives rise to a taxable transaction. (a) True (b) False

(7) Real property owned by a taxpayer and not used in a trade or business is a capital asset.

(8) Salary payments to employees serving in the Armed Forces are deductible as an expense by the employer who pays them. (a) True (b) False

(9) A taxpayer during the year pays $60 federal excise tax in connection with the purchase of a television set for his personal use. The taxpayer may deduct this $60 on his personal income-tax return. (a) True (b) False

(10) Stock owned by a taxpayer becomes entirely worthless in 1949. The taxpayer does not discover this fact until 1951. Deduction can be taken on the 1951 tax return. (a) True (b) False

(11) Bonds which cost a taxpayer $8,000 are sold in a bona fide transaction to his son, Y, for $7,000. The taxpayer may not take a deduction for the loss sustained. (a) True (b) False

(12) Estates and trusts are permitted to use the "standard deduction" in the determination of net income. (a) True (b) False

(13) T, who is on the cash basis, pays $500 in 1950 for fire insurance on his income-producing realty. The premium paid on the policy covers a three-year period. He may take this $500 as a business expense in the year 1950. (a) True (b) False

(14) P, an architect on the cash basis, renders special services extending over the period 1946-1950, for which a fee of $10,000 is charged. He received $3,500 in 1946 and the balance in 1950. P may take advantage of the "36-month, or compensation for long-term services, rule" in computing his net income for 1950. (a) True (b) False

(15) X Corporation conducts an advertising campaign during 1950, spending $100,000. It is expected that such campaign will benefit the next five years. This expense may be prorated for tax purposes over the five-year period. (a) True (b) False

(16) A taxpayer on the *accrual* basis may properly take as a deduction in the year 1950 the following:

(*a*) provision for self-insurance (a) True (b) False

(*b*) additions to a reserve for ordinary repairs (a) True (b) False

(*c*) the cost of "making good" on a guarantee in the year 1951 for sales made in 1950 (a) True (b) False

(17) The "back pay" rule is applicable to a taxpayer who received only the following during the year 1950:

(*a*) salary of $6,000 for 1950 and "back pay" of $2,000 (a) True (b) False

(*b*) salary of $5,000 for 1950, "back pay" of $1,000 and dividend income of $2,000 (a) True (b) False

b The following are to be answered by indicating the letter which identifies the correct amount for each situation.

(1) Y, an employee of X Corporation, received on June 30, 1950, as compensation, 100 shares of X Corporation common stock, par value $10 a share, which has a market value on June 30 of $14 per share. On December 31, 1950, the stock has a market value of $12 a share. Y should report as income for the year 1950 in respect to the stock received (a) 0 (b) $1,000 (c) $1,200 (d) $1,400 (e) some other amount

(2) Lessee A completes on January 1, 1940, a building costing $100,000 with an estimated life of 20 years. On January 1, 1950, the lease expires and lessor B repossesses the improved property. At that time the building has a fair market value of $80,000. B should report as income for the year 1950 in respect to repossession of the leased property (a) 0 (b) $20,000 (c) $50,000 (d) $80,000 (e) some other amount

(3) T owns a warehouse which has an adjusted basis of $40,000 and which is condemned by the state to make way for a highway. The state pays T $50,000, of which he immediately uses $46,000 to erect a new warehouse. In respect to this "involuntary conversion," T should report for income purposes (a) 0 (b) $4,000 (c) $6,000 (d) $10,000 (e) some other amount

(4) T purchased a machine on July 1, 1948, for $10,000. On July 1, 1951, it has an adjusted value of $2,500. On that day he sells the old machine for $4,500 and purchases a new machine for $9,000. The basis for the

machine purchased July 1, 1951, is (a) $4,500 (b) $7,000 (c) $8,000 (d) $9,000 (e) some other amount

(5) X, a married taxpayer with no dependents, has adjusted gross income of $6,000. During the taxable year, he paid hospitalization insurance premiums of $39, his wife's medical bill of $2,000 dental fees of $125, and fees of $25 for hire of ambulance. What amount is deductible on a joint return as medical expenses? (a) $1,250 (b) $1,589 (c) $1,889 (d) $2,189 (e) $2,500

(6) Taxpayer T who is in the business of selling vacuum cleaners on the installment plan uses the installment method of reporting income for federal income-tax purposes. In the calendar year 1950, T had sales of $20,000, the vacuum cleaners costing $15,000. Collections were made as follows: 1950—$8,000; 1951—$7,000; 1952—$5,000. The only selling and administrative expenses attributable to the above sales amounted to $800 and were all incurred and paid in 1950.

(*a*) Taxable net income for the year 1950 was (a) $5,000 (b) $4,200 (c) $2,000 (d) $1,680 (e) $1,200

(*b*) Taxable net income for the year 1951 was (a) $2,100 (b) $1,750 (c) $1,470 (d) 0 (e) some other amount

(*c*) Taxable net income for the year 1952 was (a) $4,200 (b) $1,250 (c) $1,050 (d) 0 (e) some other amount

c Mr. Charles Adams, a certified public accountant, conducts a public accounting practice in Blairtown, N. Y. During the year 1950, Mr. Adams attended the American Institute of Accountants convention in Boston. He is married and has two children. His son, James, aged 20, who attends State University, worked during the summer of 1950 and earned $300 which was his only income for 1950. His daughter, Sally, aged 12, was the recipient of a gift of $5,000 from her uncle. Mr. Adams also provided the chief support for his blind father, aged 69, who had no income. Mr. Adams' father died in November, 1950, and at his death he had a $1,000 ordinary life insurance policy payable to his son, Charles.

During the year, Mr. Adams received $18,000 in professional fees, $300 in dividends on his "GI" insurance policy (National Service Life) which has been in effect since 1942, and an auto worth $1,800 won as a prize in a raffle. Mr. Adams paid $1 for the raffle ticket. He received jury fees amounting to $40 and $150 in dividend income. His professional expenses amounted to $8,000.

Mr. Adams owns his personal residence. The November hurricane resulted in a $500 loss to his home which was covered by insurance and this loss was reimbursed to Mr. Adams in 1950. In addition, he spent $300 repairing damages to his home caused by termites. He paid $400 interest to the Blairtown National Bank on $10,000 which he had borrowed to invest in State of New York 3% bonds. He contributed to the American Red Cross 10 shares of X Corporation stock which he purchased in 1947 at $40. The stock was worth $50 a share when the contribution was made.

As a hobby Mr. Adams cultivates orchids which he occasionally sells. An unseasonable freeze destroyed plants costing $200.

The following items concern possible deductions on Mr. Adams' 1950 federal income-tax return. Some of the items are deductible in determining *adjusted gross income,* some are deductible only in determining *net income,* and some are *not deductible* at all. You are to decide into which category each item falls. Indicate into which class the items fall by use of the following letters: (a) deductible in determining adjusted gross income, (b) deductible only in determining net income, (c) not deductible.

(1) tuition paid for his son at State University

(2) payment of interest on the mortgage of Adams' residence

(3) rental cost of a safe deposit box in which Adams keeps his securities

(4) hotel expenses and rail fare incurred in attending the American Institute of Accountants convention in Boston

(5) membership dues in the American Institute of Accountants

(6) payment of penalty for late filing of 1949 federal income tax

(7) payment of interest on a deficiency in federal income-tax assessment for 1946
(8) the loss sustained by the freezing of the orchids to the extent not covered by insurance
(9) the loss caused by termites to the extent not covered by insurance
(10) the value of the 10 shares of X Corporation stock contributed to his church
(11) Adams' 1949 state income tax paid in 1950
(12) Adams' 1949 federal income tax paid in 1950
(13) the expense of cultivating the orchids
(14) the $400 interest paid to the Blairtown National Bank

The following items involve certain receipts which Adams thinks he may properly exclude as income. Indicate whether or not Adams may exclude the items by use of the following letters: (a) Yes (b) No

(15) the $300 summer vacation money earned by son, James
(16) the $5,000 gift received by his infant daughter, Sally
(17) the $300 insurance dividends on his National Service Life Insurance Policy
(18) the value of the auto won as a prize at the raffle
(19) the $40 received for jury duty fees
(20) the $1,000 life insurance proceeds received in 1950 as a result of his father's death

2 [20]

The Hardware and Furniture Company (a sole proprietorship) did not have complete records on a double-entry basis. However, from your investigation of their records you have established the information shown below. Using that information you are to prepare a balance sheet as of December 31, 1950, and an income statement for the year.

(1) The assets and liabilities as of December 31, 1949, were:

	Debit	*Credit*
cash	$ 5,175	
accounts receivable	10,556	
allowance for loss on accounts		$ 740
fixtures	3,130	
accumulated depreciation		1,110
prepaid insurance	158	
prepaid supplies	79	
accounts payable		4,244
accrued miscellaneous expenses		206
accrued taxes		202
merchandise inventory	19,243	
note payable		5,000
Roberts, capital		26,839

(2) A summary of the transactions for 1950 as recorded in the checkbook shows:

deposits for the year (including the redeposit of $304 of checks charged back by the bank)	$83,187
checks drawn during the year	84,070
customers' checks charged back by the bank	304
bank service charges	22

(3) The following information is available as to accounts payable:

purchases on account during year	$57,789
returns of merchandise allowed as credits against accounts by vendors	1,418
payments of accounts by check	55,461

(4) Information as to accounts receivable shows the following:

accounts written off	$ 812
accounts collected	43,083
balance of accounts December 31, 1950 (of this balance $700 is estimated to be uncollectible)	11,921

(5) Checks drawn during the year include checks for the following items:

salaries	$10,988
rent	3,600
heat, light and telephone	394
supplies	280
insurance	341
taxes and licenses	1,017
drawings of proprietor	6,140
miscellaneous expense	769
merchandise purchases	2,080
note payable	3,000
	$28,609

(6) Merchandise inventory December 31, 1950, was $17,807. Prepaid insurance amounted to $122 and supplies on hand to $105 as of December 31, 1950. Accrued taxes were $216 and miscellaneous accrued expenses were $73 at the year end.

(7) Cash sales for the year are assumed to account for all cash received other than that collected on accounts. Fixtures are to be depreciated at the rate of 10% per annum.

3 [15]

From the following information you are to prepare a statement showing the sources and applications of funds for the year 1950:

Balance-Sheet Accounts

Debits	*December 31 1949*	*1950*
cash	$ 40,409	$ 30,337
accounts receivable	67,186	65,638
temporary investments	112,500	85,000
prepaid insurance	710	755
inventories	82,164	94,438
cash surrender value of life insurance policies	8,315	9,061
unamortized bond discount	4,305	2,867
land, buildings, machinery and equipment	172,778	207,782
	$488,367	$495,878

Credits		
Accounts payable	$ 34,081	$ 31,314
notes payable to banks	40,000	45,000
accrued interest, taxes, etc.	12,307	21,263
first-mortgage 4% serial bonds	82,000	68,500
allowance for loss on accounts	4,630	3,815
allowance for depreciation	96,618	81,633
allowance for inventory loss	1,000	7,500
reserve for contingencies	37,500	63,600
common stock, $100 par value	100,000	92,500
paid-in surplus	11,000	10,175
retained earnings	69,231	70,578
	$488,367	$495,878

The following information concerning the transactions is available.

(1) Net profit for 1950 was shown by the profit and loss statement as $48,097.

(2) During the year 75 shares of the capital stock were repurchased at $111 and were being held in the treasury. Subsequent to the stock reacquisition a 10% cash dividend was paid.

(3) The 1950 premium on life insurance policies was $1,673. Expense was charged with $927 of this payment.

(4) Machinery was purchased for $31,365 and machinery costing $32,625 was retired. The retired machinery had accumulated depreciation of $29,105 at date of retirement. It was sold as scrap for $1,000 which was credited against the profit and loss on retirement of asset account. The remaining increase in fixed assets resulted from construction of a building.

(5) The serial bonds mature at the rate of $5,000 per year. In addition to the retirement of the $5,000 of bonds due in 1950, the company purchased and retired $8,500 of the bonds at $103. Both the premium on retirement and the applicable discount were charged to expense.

(6) The allowance for inventory loss was created by a charge to expense in each year. It is set up to reduce the inventory value of obsolete items to estimated market value. Bad accounts of $3,702 were written off against the allowance for loss on accounts.

(7) The reserve for contingencies was provided by charges against retained earnings. A debit to the reserve of $11,400 was made during the year. This represented the final settlement of a part of 1947 income-tax liability which had been the subject of controversy.

PRACTICAL ACCOUNTING — Part II

Thursday, November 8, 1951—1.30 to 6 p. m., only

Solve problems 1 and 2 and either problem 3 or problem 4.

1 [12½]

As of January 1, 1942, Grant leased a building for 10 years to be used as a retail store. His agreement with the owner was as follows:

The annual rent payment was to be based on gross sales. On sales up to $150,000 per year the rate was to be 3%. On any sales in excess of $150,000 per year the rate was to be 2%.

However, during the first five years of the term of the lease, the annual rental was to be a minimum of $4,000 per year after which the minimum was to be increased by 12½%.

The lease further provided that if in any one year the rent based on sales did not equal the minimum annual rental, the minimum would be payable, but the amount paid solely as a result of such minimum could be applied in reduction of the next year's rent to the extent that the next year's rent exceeded the minimum for that year.

Gross sales by years including 1951 were as follows:

1942..........	$ 96,000	1947..........	$141,000
1943..........	129,000	1948..........	165,000
1944..........	148,000	1949..........	142,000
1945..........	161,000	1950..........	170,000
1946..........	124,000	1951..........	197,000

a You are to compute the amount of rent payable each year under the terms of the lease.

b Discuss the treatment in the financial statements of any amounts payable under the provision for payment of a minimum amount of rent.

2 [12½]

The balance sheet of the S Company on September 30, 1951, has the following items on the credit side of the statement:

Current liabilities	$103,732
Bonds payable	300,000
Reserve for bond retirement...	160,000
6% Cumulative preferred stock, $100 par value, (entitled to $110 and accumulated dividends per share in voluntary liquidation and to $100 per share in involuntary liquidation). Authorized—3,000 shares, issued—2,000 shares, in Treasury—150 shares..................	185,000
Common stock, $100 par value, authorized—10,000 shares, issued and outstanding 4,000 shares	400,000
Premium on preferred stock...	10,000
Premium on common	67,300
Retained earnings	131,260

The company proposes to finance a plant expansion program by issuing an additional 2,000 shares of common stock. Common stockholders of record October 1, 1951, were notified that they will be permitted to subscribe to the new issue at $150 per share up to 50% of their holdings. The market value of the stock on October 1, 1951, was $172.50 per share. The stock goes ex-rights in the market on October 3, 1951.

John Doe owns 100 shares of the S Company common which he purchased in 1949 for $16,431.20. He does not want to exercise his rights but wishes to sell them.

a You are to compute the book value of a share of common stock as of September 30, 1951. Preferred dividends have been paid or set up as payable through September 30, 1951.

b You are to compute the theoretical value of John Doe's rights as of October 1, 1951.

c You are to state the federal income-tax rule as to stock rights and show the computation and treatment of the transaction if Doe sells his rights for $800. Indicate any further assumed facts on which your computation is based.

Solve either problem 3 or problem 4.

3 [25]

The following balances appear on the books of Memorial Hospital as of January 1, 1950:

	Debits	*Credits*
Cash on hand and in banks	$ 143,866	....
Accounts receivable—patients	48,740	....
Sundry accounts receivable	508	....
Inventory of supplies	17,583	....
Prepaid insurance	3,294	....
Stocks and bonds	3,702,010	....
Other investments	225,950	....
Land	25,000	....
Buildings	402,305	....
Equipment	106,500	....
Allowance for loss on accounts	....	$ 10,385
Accounts payable	....	29,227
Other current liabilities	....	38,014
Bonds payable—1st mortgage 5%	....	300,000
Advance payments by patients	....	6,364
Balance	....	4,291,766
	$4,675,756	$4,675,756

From the following information and summary of the transactions for the year ended December 31, 1950, you are to prepare work sheets showing by appropriate funds all information needed for (*a*) a statement of income and expense for the year and (*b*) a balance sheet for each fund as of December 31, 1950. Changes in surplus accounts or in fund balances should be shown in additional columns unless all such changes are clearly identified in the balance sheet columns.

(1) The stocks and bonds together with $112,808 of the cash belong to endowment funds, the income of which may be used for general purposes of the hospital. An additional $12,150 of cash belongs to specific expendable funds. Buildings and equipment and stated net of depreciation which has been charged to the current expenses of each year. There is no intention to provide a fund for replacement of assets, and as assets are replaced, payments are made out of general cash. The other investments belong to endowment funds for specific purposes. The income from these funds may be used only for the designated purposes.

(2) Cash income from endowment fund stocks and bonds amounted to $138,710. Income from other investments amounted to $11,765.

(3) Cash donations received amounted to $41,305, all except $10,500 of which was for current use. The $10,500 was expendable only for a designated purpose.

(4) Services rendered pay patients amounted to $930,480 which was all recorded through accounts receivable—patients.

(5) Cash collected from patients and prospective patients amounted to $925,428, of which $12,890 represented advance payments.

(6) Cash of $1,275 was collected on sundry accounts receivable.

(7) The allowance for loss on accounts was increased by $10,000. Patients' accounts totaling $6,302 are considered to be uncollectible and were written off.

(8) Depreciation on the buildings was $11,307. Depreciation on equipment was $18,541.

(9) The following vouchers were approved: Storeroom supplies—$78,240; Insurance—$11,624; General operating expenses—$979,731; Maintenance—$7,448; Replacement of equipment—$11,432; Interest on bonds—$15,000; Retirement of bonds—$10,000. Other current liabilities were credited with $505,212 of these $1,113,475 of vouchers.

(10) The carrying value of equipment replaced was $2,710.

(11) Free services rendered during the year amounted to $108,000.

(12) Services rendered patients (see No. 4) were covered by advance payments amounting to $14,105.

(13) Cash disursements were made of $502,701 in payment of other current liabilities and $610,043 in payment of accounts payable. Discounts taken on accounts payable amounted to $2,305.

(14) Storeroom supplies of $72,578 were issued for general use and $1,073 of supplies were sold to employees and charged to sundry accounts receivable. Insurance expired amounted to $10,445.

(15) Cash expenditures from specific expendable funds were $5,875.

(16) Cash receipts for the year included unexpendable cash contributions of $50,000, proceeds from sale of stocks and bonds of $502,164 and proceeds from sale of other investments of $52,125.

(17) Cash disbursements not vouchered consisted of $507,892 for purchase of stocks and bonds and $48,100 of the proceeds from sale of other investments which was invested in bonds.

(18) There was a loss of $7,354 sustained on the sale of stocks and bonds and a $9,978 loss sustained on the sale of other investments.

4 [25]

The Town Company is a manufacturer, producing two principal products known as XO and MO. Incidental to the production of these products, it produces a by-product known as Bypo. The company has three producing departments which it identifies as departments 101, 201 and 301. Raw materials A and B are started in process in department 101. Upon completion of processing in that department one-fifth of the material is by-product and is transferred directly to stock. One-third of the remaining output of department 101 goes to department 201 where it is made into XO and the other two-thirds goes to department 301 where it becomes MO. The processing of XO in department 201 results in a gain in weight of material transferred into the department of 50% due to the addition of water at the start of the processing. There is no gain or loss of weight in the other processes.

The company considers the income from Bypo, after allowing five cents per pound for estimated selling and delivery costs, to be a reduction of the cost of the two principal products. The company assigns department 101 costs to the two principal products in proportion to their net sales value at point of separation, computed by deducting costs to be incurred in subsequent processes from the sales value of the products.

The following information concerns the operations during April 1951:

INVENTORIES

	March 31		*April 30*
	Quantity (Pounds)	*Value*	*Quantity (Pounds)*
Department 101	None		None
Department 201	800	$17,160	1,000
Department 301	200	2,340	360
Finished stock—XO	300	7,260	800
Finished stock—MO	1,200	18,550	700
Finished stock—Bypo	None		None

Inventories in process are estimated to be one-half complete in departments 201 and 301, both at the first and last of the month.

COSTS

	Material Used	*Labor and Burden*
Department 101	$134,090	$87,442
Department 201	—	31,950
Department 301	—	61,880

The material used in department 101 weighed 18,000 pounds.

SALES PRICES

XO	$29.50	per pound
MO	17.50	" "
Bypo	.50	" "

Prices as of April 30th are unchanged from those in effect during the month.

You are to prepare the following statements covering the operations of the Town Company. Present all supporting computations in good form.

a Statement showing costs and production by departments for the month of April. The company uses first-in, first-out to cost out production.

b A schedule of inventory values for work-in-process and finished goods as of April 30.

New York State Tax Forum

Conducted by BENJAMIN HARROW, C.P.A.

Franchise Tax—Allocation

THE principle behind the allocation provisions in the law is that a corporation doing business within and without the State should be taxed only on that portion of its income or capital representing business done within the State. That would seem to be a fair basis for taxation. The actual determination of the income or capital representing New York business is made according to a complicated series of provisions in the law, many of them quite technical. Fitting into these provisions becomes a problem beset with practical considerations.

Let us analyze an actual case. A corporation is principally engaged in the jobbing business. It imports textiles and also purchases greige goods in the domestic market. The latter are processed at mills in other states. The corporation has sales offices in several states. Only one of these offices is maintained by employees of the corporation. The others are maintained by salesmen who are independent contractors. Merchandise is stored in public warehouses in these states and, also, at the processing mills. Orders for the sale of merchandise are accepted at the several offices, although the main office in New York receives a copy of all orders, and all the billing is done in New York. To what extent may the corporation allocate any of its income outside the state?

BENJAMIN HARROW, C.P.A., has been a member of our Society since 1928. He is a Professor of Law at St. John's University.

Mr. Harrow has been a member of the American Institute of Accountants since 1922 and is a member of the New York Bar. He is now serving on the Society's Committee on Federal Taxation, and is Chairman of its Committee on State Taxation. He is also a member of the Institute's Committee on Federal Taxation and its Council.

Mr. Harrow is engaged in practice as a certified public accountant and attorney in his own office in New York City.

Regular Place of Business and Permanent or Continuous Place of Business

Before any allocation is permitted, a corporation must have at least a regular place of business outside the state. The Regulations (Art. 411) define this as "any bona fide office (other than a statutory office), factory, warehouse, or other space which is regularly used by the taxpayer in carrying on its business." Under the facts stated above, the offices of the corporation in other states, the public warehouses in those states, and the mills in other states to which merchandise is consigned would each qualify as a regular place of business. The Regulation states that a public warehouse, where merchandise is stored until shipped, is considered a regular place of business if that is done as a regular course of business. The Regulation also states that if raw materials or partially finished goods are delivered to an independent contractor to be processed "and the finished goods remain in the possession of the independent contractor until shipped to customers, the plant of such independent contractor is considered a regular place of business of the taxpayer."

It should be noted that having a regular place of business does not give

a corporation a complete allocation under all the factors. The allocation would be permitted only under the property factor and the payroll factor. The sales would all be allocated to New York under the gross receipts factor unless the corporation had something more than a regular place of business. The place of business outside the state would have to be a permanent and continuous one, that is an office, factory, warehouse or other space outside New York, "at which the taxpayer is doing business in its own name in a regular and systematic manner, and which is continuously maintained, occupied and used by the taxpayer in carrying on its business through its regular employees regularly in attendance." (Art. 413.2).

Under the facts stated above, the warehouses and the mills would not qualify as permanent and continuous places of business, unless they could come squarely within the definition given in the Regulation. Of the offices of the taxpayer outside the state, only one could qualify as a permanent and continuous place of business, since the others were maintained by salesmen who were independent contractors and not employees of the taxpayer, even though the taxpayer paid rent to the independent contractors.

Receipts Factor—Receipt of Order and Appropriation to the Order

The allocation of receipts outside New York also depends upon the place where the merchandise is located at the time time the order is received, or at the time the merchandise is appropriated to the order. If a salesman receives an order for merchandise at taxpayer's office outside New York and the merchandise is at that time located in New York, the sale is considered as a New York sale allocable to New York. If the merchandise is not in New York at the time the order is received outside the State, but is in New York when the merchandise is shipped, again the sale is a New York sale. This would be so, even though the merchandise was outside New York when it was set aside or earmarked for the customer who ordered the merchandise.

For the sale to be allocated outside New York, the merchandise must be located at a permanent and continuous place of business outside the state, at the time of the reiceipt of the order or at the time the merchandise is appropriated to the order. In addition, if the taxpayer has a permanent or continuous place of business outside the state, but the merchandise is located at a public warehouse in that state (a regular place of business), the Regulations (Art. 413.2) seem to indicate that the sale would be allocable outside New York, provided the order is both received and accepted outside New York.

If an employee or agent works out of a permanent place of business in New York, orders received or accepted by him are deemed to be received or accepted in New York, no matter where the employee actually receives the order. If any act is done in New York to make the contract binding, an order is deemed to be accepted in New York.

Rented Real Property in the Property Factor—Allocation

The question has been asked whether rent received by a taxpayer from the sub-lease of real property rented by a taxpayer may be offset against rent paid by the taxpayer for the purpose of computing gross rents payable in the determination of the rented property factor for New York Franchise Tax purposes.

The 1949 legislature amended Art. 9A to include in the property allocation factor the value of property rented to a taxpayer as well as property owned by it. The value of such property is deemed to be eight times the gross rents payable during the period covered by the report. According to Art. 412.1 of the Regulations, gross rents do not include amounts paid for storage unless the taxpayer controls a designated space as a tenant.

The Regulations say nothing specifically concerning subleases. The provision with respect to storage space indicates the position the Tax Commission would take on the question of subleases. In our opinion, if a designated space is under the control of a subtenant and the subtenant pays rent for this specific space, gross rent would exclude the rental received from the subtenant.

Art. 412.1 also provides that if the general method of valuing rented property results in inaccurate valuations, the Tax Commission may accept any other method which properly reflects a more accurate value. This provision would probably enable a taxpayer to argue that gross rents should exclude the rental income received from a subtenant. In any event this procedure may not be used without the approval of the Tax Commission.

Property Factor—Goods in Transit

The property factor is the ratio of the value of real and tangible personal property within New York to the value of all such property within and without New York. The situs of goods in transit is important in the determination of this ratio.

If goods are in transit from a point outside New York to a point in New York or vice versa, the goods are deemed not to have a fixed situs anywhere. The value of such property is therefore omitted both from the numerator and the denominator of the property factor. If goods are in transit from a point outside New York to another point outside New York, they are deemed to have a situs without the state and the value would be included in the denominator of the property factor. This of course will reduce the income to be allocated to New York. If the goods are in transit from one point in New York to another point in New York, they are deemed to be situated in New York and the value would be included both in the numerator and the denominator of the property factor.

Property is no longer in transit after it has been delivered to the owner at the point of destination. Merchandise stored in a bonded warehouse in New York has a situs in New York and would of course be included in the numerator and denominator of the property factor.

Franchise Tax Return—Base Period Different From Federal Return

The franchise tax is assessed for the privilege of doing business in this state. Under the entire net income basis, net income required to be reported for federal income tax purposes is the starting point for determining entire net income for franchise tax purposes. Suppose a foreign corporation that files its federal income tax return on a calendar year basis commences doing business in New York on March 1 of the year. How will such a corporation compute its entire net income for franchise tax purposes for the first calendar year?

Such a corporation will be taxed for the first franchise tax year only on the basis of entire net income for the actual period that it was doing business in New York. The net income, as per federal return, is first adjusted for additions and eliminations to determine entire net income for the full twelve months. The result is divided by twelve to determine average entire net income for one month and the result is then multiplied by the actual number of months that the corporation was doing business in New York. Art. 314 of the Regulations outlines this procedure.

Franchise Tax—Deduction for Interest Paid by a Subsidiary to a Parent

A subsidiary corporation pays interest to a parent company on indebtedness arising from the factoring of accounts receivable of the subsidiary. The parent company is regularly engaged in the factoring business. To what extent is the interest deductible

in determining entire net income of the subsidiary for franchise tax purposes?

Under Sect. 208 of the Franchise Tax law, the deduction for interest is limited to 10% or $1,000.00, whichever is larger, if paid to any stockholder or shareholder owning in excess of five per cent of the issued capital stock of the taxpayer. This provision was originally inserted in the law to prevent thinly capitalized corporations from obtaining a tax advantage through the deduction as an ordinary and necessary expense of payments of interest on bonded or open indebtedness where the latter essentially represented capital invested in a business. It was probably not the original intention of the Tax Commission to limit the deduction for interest where this constituted an ordinary and necessary expense incurred in the operation of a business, such as the well recognized business of factoring accounts receivable. The law however makes no exception in its provisions for limiting the deduction for interest. Perhaps the Tax Commission should give consideration to this situation and recommend an amendment to the law to allow a full deduction for interest where it is an ordinary and necessary expense incurred in the operation of a business.

Under new Art. 9A, the parent company gets a tax advantage because of the interest it receives from the subsidiary company. Subsidiary income generally is not included in the determination of the entire net income of the parent. In the case of interest received from a subsidiary there is a limitation on this exclusion. Only the interest not taken as a deduction by the subsidiary company is excluded from entire net income of the parent. This limitation was put into the law to prevent a duplication of tax advantage, once to the subsidiary as a deduction and again to the parent as an exclusion.

Recovery of a Bad Debt

Generally, any recovery of a bad debt charged off and deducted in a prior taxable year is taxable income. Under the tax benefit principle there is an exception to this rule under both the federal and New York tax laws. The New York law provides that the recovery may be excluded from income to the extent that the prior deduction did not reduce the income tax liability for the year in which the deduction was taken and the bad debt was deducted within three years prior to the year in which the recovery was made. The federal law does not have any limitation as to the time that the deduction was taken.

Estate Tax—Survivorship Annuity to Widow of Retired City Employee

Sec. 5, Art. XVI, of the New York State Constitution provides that all "salaries, wages and other compensation, *except pensions*" paid to employees of the state and its subdivisions shall be subject to taxation. Does the exemption of pensions from taxation extend to the estate tax on a survivorship annuity to a wife under a pension received by a retired city employee during his life time? This question had been before the Surrogate's Court,[1] which held that it was unconstitutional to tax the commuted value of the annuity as part of the gross estate of the husband. The State Tax Commission asked for a reargument and the Surrogate's Court [2] affirmed its prior determination.

The Tax Commission argued that the constitutional provision exempting pensions applied only to pensions paid to the employee and not to pensions paid to a widow of an employee. The court held that if the Tax Commission was right in its literal interpretation of

1 *In re Endermann's Estate,* 106 NYS 2d 849 (July 31, 1951).

2 *Matter of Hermann K. Endermann, dec'd.* Queens County; N.Y.L.J., November 9, 1951, page 1196.

the Constitution the exception as to pensions would be meaningless. It held that the Constitution should be construed broadly, that the delegates to the Constitutional Convention of 1938 thought they were exempting pensions of state employees from all forms of taxation. The payments to the widow were a continuation of the employee's pension. To subject the pension to an estate tax and not to an income tax would result in an inconsistency not indicated by the context.

The Tax Commission argued that it was not the pension itself that was being taxed, but the right to transfer it at death. The court meets this argument by saying that, whatever the theory, a tax is sought because there is a pension: "This does not mean that they (pensions) are not subject to direct taxation. It means that they may not be used in any manner as a basis for computing any kind of tax."

This decision seems to run counter to the basic theory of the estate tax as an indirect tax on the transfer of property at death. The U. S. Supreme Court has upheld[3] an estate tax on the transfer of property which was exempt from direct taxation; municipal bonds, for example. Unless the exemption from tax specifically includes the estate tax, there would seem to be no basis for the liberal construction the court found in this case. The Tax Commission will probably take an appeal from this decision.

Estate Tax—Inter-vivos Gifts

The gross estate subject to the estate tax consists, first, of all property the decedent owned at his death. It also includes property the decedent may have transferred during his life-time over which he has exercised rights of ownership or control, or over which he has retained certain rights that normally go with ownership. If, for example, a decedent during his life-time transfers property irrevocably, retaining the income until his death, the value of the property so transferred will be includible in his gross estate.

In a recent case,[4] a decedent had conveyed some real estate to grandchildren. The deeds were recorded and a gift tax return was filed reporting the conveyances as gifts. The decedent continued to collect the rents and reported them as his income. He never made any accounting to the grandchildren for the rents. In his will he mentioned the gift to the grandchildren, adding that the gift was subject to his rights to the rents for life.

The Commissioner included the value of the property conveyed in the gross estate on the ground that this was a transfer of property by trust *or otherwise,* where the decedent has retained the possession or enjoyment of, or the right to the income from the property. The executor contended that the deeds divested the decedent of all the incidents of ownership. The court held that the decedent never completed the gifts. Dominion and control were never relinquished. Not even legal title vested in the grandchildren, since the deeds were never delivered to them. A gift requires acceptance by the donee. Here the donees did not even know that deeds had been executed in their favor.

Legal title is only one element of ownership of property. The rights the decedent exercised with respect to the properties are normally associated with ownership and, under the estate tax law, these rights are more important than the mere legal title. As the court put it, the treatment of the properties was utterly inconsistent with the usual divestiture of all right, title and interest that accompanies a fee simple conveyance.

Sale of Real Estate Under a Deferred Payment Contract—When Does Tax Accrue?

Normally, a sale is evidence of a completed transaction resulting in the

[3] *Greiner* v. *Lewellyn,* 258 U.S. 384 (1932).
[4] *Estate of John W. Mortimere* v. *Com'r.,* 17 TC, No. 62 (Oct. 2, 1951).

realization of income. The tax accrues at the time of sale. Taxable income is represented by the difference between the selling price and the cost or other basis. If the selling price consists of cash there is no problem. If the selling price includes any equivalent of cash, such as a mortgage or note, there is likewise no problem since the market value of the mortgage or the note is deemed to be the equivalent of cash. Suppose the sale does not involve any evidences of indebtedness and the cash received in the year of sale is less than the cost of the property? In a recent case on this point[5] the Tax Court held that there is no realization of income until the year in which the taxpayer has recovered his basis.

In this case the taxpayer entered into a contract to sell real and personal property for $70,000 with a down payment of $8,000. The balance was payable monthly, over a period of years. The deed was to be delivered upon the completion of payments. The contract did not provide for any mortgage security or note for the unpaid indebtedness. The Commissioner argued that the contractual obligation to pay the balance in deferred payments was the equivalent of cash and had a present market value. The court held otherwise, saying that the unsecured promise to pay was not equivalent to a mortgage and nothing was realized that could be considered an equivalent of cash. Two judges dissented stating that the withholding of the deed was equivalent to the execution of a deed and to the taking back of a mortgage.

The effect of the decision was to defer any realization of income for two years until the taxpayer had recovered the cost. After that, all additional payments would represent taxable income. It should be noted that the taxpayer could have treated the transaction as an installment sale and reported each year a proportionate share of the total gain based upon the cash received.

Installment Sales

Reporting income on this basis enables a taxpayer to spread a gain resulting from a sale of property over the period in which he is receiving installment payments. The use of the installment method is restricted to sales of property where the "initial payments" received during the year of sale do not exceed 30% of the sales price. It should be noted that "initial payments" are not limited to a down payment but include any subsequent payments received during the year of sale. The total payments during the taxable year of sale must not exceed 30% of the sales price. They may, of course, be less than 30%, and there need not be more than one payment during the year of sale, but there must be at least one payment.

The method of reporting the portion of each installment that represents taxable income is a simple computation. The taxpayer first determines the total profit on the transaction. Then he determines the percentage of profit to the contract price, usually the selling price, technically the total payments to be received by the seller. The percentage so determined is applied to each installment payment and the result is the taxable income.

[5] *Ennis*, 17 TC (No. 51), September 27, 1951.

Accounting at the S. E. C.

Conducted by Louis H. Rappaport, C.P.A.

New York Regional Office Moved

The regional office of the SEC in New York is now at 42 Broadway, New York 4, N. Y. Its new telephone number is WHitehall 3-3460. If you have any question involving the work of the SEC, the Interpretative Section at this location may be able to help you.

Amendments to Form S-1

The SEC has made a number of minor amendments to its recently revised Form S-1. (This is the principal form for registering securities for sale to the public under the Securities Act of 1933.) The only amendment affecting the work of the public accountant is a change in one of the General Instructions relating to omission of financial data from the prospectus. The amended instructions make it clear that the historical financial information required by Part E of the Instructions as to Financial Statements may be omitted from the prospectus. (Part E is that portion of the financial requirements which deals with write-ups and write-downs of fixed assets, intangibles, investments, etc., during the period of seven years preceding the period covered by the formal financial statements.)

Louis H. Rappaport, C.P.A., has been a member of the Society since 1933. He is a partner in the firm of Lybrand, Ross Bros. & Montgomery, C.P.A's., and is also a member of the American Institute of Accountants and of the American Accounting Association.

Proposed Amendments to Proxy Rules

The SEC has announced that it has under consideration a number of proposals to amend its proxy rules under the Securities Exchange Act of 1934.

The principal proposed amendments of interest to accountants are as follows:

1. *Definition of "associate."* The definition of the term "associate" would be expanded to include certain relatives of specified persons who are not now included in the definition.

This proposal is of more interest to accountants than might appear to be the case. If a proxy is solicited for a meeting at which action is to be taken with respect to the selection of auditors, then information must be furnished in a proxy statement in response to the following requirement:

> Item 8. Selection of Auditors
>
> If action is to be taken with respect to the selection of auditors, or if it is proposed that particular auditors shall be recommended for selection by any committee to select auditors for whom votes are to be cast, name the auditors and describe briefly any material relationship of such auditors or any of their associates with the issuer or any of its affiliates.

The SEC proposes to amend the definition of "associate" so that it would read as follows:

> *"Associate.* The term 'associate' used to indicate a relationship with any person, means (1) any corporation or organization (other than the issuer or its subsidiaries) of which such person is an officer or partner or is, directly or indirectly, the beneficial owner of 10 percent or more of any class of equity securities, (2) any trust or other estate in which such person has a substantial beneficial interest or as to which such person serves as trustee or in a similar fiduciary capacity, and (3) any relative or spouse of such person, *or any relative of such spouse,* who has the same home as such person *or who, to the knowledge of*

such person, is employed or retained by or deals with the issuer or any of its affiliates in any capacity." (italicized matter is new.)

Under the present definition, the auditor's "associates" include his relatives *who have the same home as the auditor.* Under the proposed amendment, the term "associate" would also apply to the auditor's relatives not living with him who, to his knowledge, are employed or retained by or deal with the issuer or its affiliates in any capacity. It will be apparent that the proposed amendment represents a considerable enlargement in the scope of the term "associate." Suppose, for example, that you are the independent public accountant for Corporation X. Your wife's brother, who does not live with you, is employed by Corporation X as a salesman. Under the present definition, your brother-in-law is not your associate; under the proposed definition he would be an associate. And that would also be true if he were counsel for Corporation X or any of its subsidiaries or had, to your knowledge, any dealings with the companies. Although your brother-in-law might be your "associate" under the proposed definition, that fact would be significant only if his relationship with the companies were significant. Thus, if your brother-in-law were an obscure shipping clerk in Corporation X, that relationship would probably not have to be spelled out in the proxy statement. But if your brother-in-law were treasurer of Corporation X, that, in all likelihood, would be considered a material relationship of an "associate" of the auditor with the issuer and would have to be disclosed in the proxy statement.

2. *Preparation of financial statements.* Item 15 of the proxy requirements specifies the financial statements which must be included in the proxy statement in certain cases. It is proposed to add an instruction to this item to make it clear that such statements shall be prepared and certified in accordance with the Commission's Regulation S-X.

3. *Other proposals.* The SEC is considering a number of other changes in its proxy rules which do not directly affect the work of the public accountants but which will be of great interest to issuers. In connection with the remuneration of directors and certain officers, for example, it is proposed to add a new tabulation showing their expense allowances. The present requirement for a separate showing of their bonuses would be eliminated, as would information as to increases in their remuneration during the year. Information presently required as to pension and retirement benefits of directors and officers would be placed in a separate tabulation with all other forms of deferred compensation. Information would also be required as to the remuneration in excess of $25,000 of "associates" of certain persons including officers and directors.

The SEC invited all interested persons to submit data, views and comments on its proposals before February 29, 1952. It is probably not too late even now to write the SEC if you have any comments. The proposals in detail were set forth in Release No. 4668 under the 1934 Act.

Notes on the New York State Unemployment Insurance Law

Conducted by SAMUEL S. RESS

Employers Right to Hearing

THE question as to whether or not an Employer's objection to a local office determination was timely, is considered in Referee's Case No. 538-521-51R. This decision is the first one handed down in connection with an Employer's objection to being charged with Unemployment Insurance benefit payments as set forth in the Notice of Experience Rating Charges on Form IA 96.

In the case decided by a Referee, a claimant filed for Unemployment Insurance benefits on March 5, 1951, and continued as a benefit claimant for over six months. The claimant received twenty-two benefit payments of $19.00 each. In August, the Employer received an Experience Rating charge from the Unemployment Insurance Division on form IA 96, charging his account with benefit payments to the claimant for the week ending July 29, 1951. The Employer objected to the charge, as well as to any further payments to the claimant, and requested a hearing. The Employer forwarded the $10.00 deposit required.

At the hearing, a partner in the Employer firm testified that the Employer's objection was based upon the fact that the claimant had left her employment in the first quarter of 1951 without good cause. The Employer further refused to rehire her. The Employer stated that he had informed the local office of the circumstances under which the claimant had left her position and that the Employer subsequently received an initial determination from the Insurance Office that the claimant was entitled to benefits without disqualifying conditions. The Employer failed to ask for a hearing within 20 days after the receipt of that initial determination in March of 1951. However, when he received the notice of benefit charges for the week ending July 29, 1951, on August 20, 1951, he requested a hearing. At the hearing, the Referee found in favor of the claimant. He held that the Employer was not entitled in August to contest the initial determination dated and issued to the Employer on April 3, 1951, which declared the claimant eligible for benefits without disqualifying conditions.

The alleged disqualification issue was whether or not the claimant had good cause to leave her employment. The Referee held that that issue could have been litigated back in April, provided that the Employer had requested a hearing before the expiration of the 20-day period. The subsequent notification of benefit charges given by the Division did not give the Employer a second chance to reopen the issue regarding the claimant's unemployment in March.

The Referee overruled the Employer's objections and the initial determination charging the Employer's Experience Rating Account with a benefit payment to the claimant for the week ending July 29, 1951, was sustained. The Referee further held that the Employer was not entitled to the return of the $10.00 deposit under Section 620.1 (c) of the law.

The Unemployment Insurance Divi-

SAMUEL S. RESS has been an Associate Member of our Society since 1936, and is also a member of the Bar. He has specialized in the payroll tax field since the inception of this type of legislation in 1936.

Dr. Ress is a member of the Society's Committees on Clothing Manufacturing Accounting and on Labor and Management.

sion has acquiesced in the ruling of the Referee in this case. However, it has indicated that in the present case, a clear-cut one time issue was involved, i.e., whether or not the claimant quit her job voluntarily and without good cause. It indicated that its decision would have been different if the issues in the case involved the question of availability for employment during the period of unemployment.

Where the issue of availability for employment arises, the Division feels that the hearing request could be considered timely regarding any period within 20 days prior to the hearing request.

Refusal of Employment Without Good Cause

The Appellate Division has reversed the Appeal Board in Case No. 26862-51. The issue involved was whether or not the claimant had good cause for refusal of employment as a general stenographer at a salary of $41.00 a week, where her former salary as a chemical stenographer paid $58.00 a week. The Court held that the possession of a specialized skill such as that of chemical stenographer does not constitute good cause for refusal of employment as a general stenographer. The Court stated that the full utilization of all skills was not the effective test to be applied under the statute, but rather the availability of work for which the claimant is fitted by training and experience.

The Court also disregarded the difference between the claimant's former salary of $58.00 a week as against the $41.00 salary offered with the refused job.

In its decision the Court pointed out that the claimant had been employed for about six years as a stenographer and typist for a chemical company. When she left this employment due to pregnancy she was receiving $58.00 a week. When she returned to the labor market she filed a claim for unemployment insurance benefits and 4 months later she was offered employment as a stenographer at $180.00 a month. The going rate for experienced stenographers in that area was then $40.00 to $45.00 a week. The claimant refused the offer because she was dissatisfied with the salary and objected to travelling one-half hour by bus.

The Appeal Board found in favor of the claimant on the ground that the claimant's training and experience as a chemical stenographer entitled her to seek employment at a skill comparable with her previous employment.

The Court reversed the Appeal Board and stated that the test to be applied under the statute was the availability of work for which the claimant is fitted by training and experience. The Court cited a number of judicial interpretations in prior cases involving the same issue.

In *Matter of Delgato* (278 App. Div. 237), a sewing machine operator, who had completed a training course as hairdresser, without good cause refused employment in her usual occupation. The Court held in that case that where a person is reasonably fitted for more than one kind of employment, he does not bring himself within the benefits provided by the Unemployment Insurance Law if he refuses one kind of job merely because he prefers another type of work.

In *Matter of Strazza* (278 App. Div. 1036), the claimant refused employment for which he was reasonably fitted by training and experience. The claimant was trained to bake Italian and French style bread and cakes. He was offered a job as a baker of American-style bread and rolls. He refused that job. It was held that his refusal was without good cause because the statute does not contemplate such a precise selection of employment.

In another case, *Matter of De Bruyne* (278 App. Div. 1036), the claimant was a fur finisher and was unemployed because of a seasonal lull in her industry. She was offered a job in a sewing position. The Court held that the refusal of a job in the claimant's highest

skill was unwarranted where there are no reasonable employment opportunities in that skill because of seasonal conditions. The Court further held that if the claimant is fitted by training and experience for the job offered, even though the wages are appreciably below those paid for the higher skill, the claimant cannot refuse the proffered employment without losing her Unemployment Insurance benefits.

Name Band Leaders and Musicians Held Employees

The Appellate Division has again decided in a decision handed down January 9, 1952, that leaders of certain "name" orchestras which were engaged to play at the Hotel "X" were employees and not independent contractors. The members of the bands were held to be employees of the hotel and not employees of the leaders. The leaders and musicians involved operated under written contracts which designated them as employees. There was some evidence of rather trifling acts of control on the part of the management of the hotels where the orchestras played. The Court stated " . . . neither the Referee nor the Board apparently ever made any attempt realistically to appraise the relationship in the light of common law principles as was done in the case of *Bartels* vs. *Birmingham* (332 U. S. 126). However, under the decisions of this State, we think the decision of the Board must be affirmed as being within the realm of fact . . ." (citing cases, including *Matter of Roseland Amusement Co., Inc.*, 269 A. D. 713; affirmed, 295 N. Y. 913.)

In the *Bartels* case it was decided that, for federal social security purposes, "name" band leaders were independent contractors and the members of the orchestra were employees of the band leader rather than of the purchasers of the music.

Determination of Base Year Earnings

A salesman had been changed from a drawing account to a straight commission basis of payment. The question arose in Referee's Case No. 538494-51R whether a salesman had 20 weeks of employment during his base period, as required by section 527 of the Unemployment Insurance Law. The claimant had previously been employed for 14 weeks with an Employer other than the one involved in this case. The latter Employer included the claimant on his payroll for a total of 5 weeks, with total payments of $200.00. The claimant testified that he was hired by the sales manager of the Employer at $40.00 a week. For the first 3 weeks he attended a sales training course and incidentally tried some sales work. At the end of the first 3 weeks he went out into the field to sell. He lost his employment 6 weeks after he was hired. He claimed he had only been paid for five weeks. At the end of the fifth week the claimant was told that he could continue working for the Employer, but would not be allowed a drawing account. The claimant tried to earn some commissions by sales activities during the sixth week but was unsuccessful. The Employer had indicated that if the claimant had consummated a sale during the sixth week he would have been paid his normal drawing account of $40.00. The claimant had sued the Employer for $40.00 in the Small Claims Court, but had not been successful on the ground that the claimant had not made any sales and was not entitled to any commissions or drawings.

The Referee held that the claimant had performed services of the same character in the final week of his employment as he had performed previously; the only difference was in his method of operation. He was not paid any drawing account against commissions for that week. In all other respects he was subject to the Employer's supervision, direction and control. The Referee further held that the judgment of the Small Claims Court does not alter his finding that the claimant was an employee during that sixth week.

Office and Staff Management

A forum for the exchange of views and information on all aspects of the administration of an accounting practice.

Conducted by MAX BLOCK, C.P.A.

Tax Department Mechanics

Collecting Personal Income Tax Data

One of the major problems of the personal income tax period is the collection of the required data from the individuals. A substantial saving of time can be effected by having the taxpayer assemble his data prior to conferring with the accountant. It is even possible, where a well designed form is used for the assembly of tax information, that the material may be mailed to the accountant. In the latter event, a personal conference can be arranged if desired as a matter of policy, or if made necessary by unsettled problems that cannot be disposed of on the telephone.

Some accounting firms mail to their clients a form (questionnaire) which they are asked to complete and either mail or deliver in person. These forms, if properly completed, generally permit the preparation of the personal returns in short order. In time, as clients become accustomed to the form, they fill it out with increasing accuracy and thoroughness.

The questionnaire becomes a part of the workpapers for the related return. Accountants who feel that the data submitted by the taxpayer should carry his signature provide for the signature and even some representation to go with it. The form used by a representative accounting firm has been made available for publication and is reproduced on page 192. When folded, the form fits conveniently into the office copy of the return.

MAX BLOCK, C.P.A. (N.Y., Pa.) is a Director of the New York State Society of Certified Public Accountants and has been the chairman of the Society's Committee on Administration of Accountants' Practice. He is a member of the firm of Anchin, Block & Anchin.

Controls

There are a number of loose ends in tax practice which must not be permitted to be "lost in the shuffle." Some control record must be established to avoid oversights and mishaps which otherwise can happen, with attendant embarrassment. Here are two common situations:

1. In instances where expenses are capitalized, credit for depreciation or amortization of the amount amortized should be taken in specified future years. Where returns have already been filed for one or two of these future years, as is often the case, the taxpayer has either of two alternatives, namely, to file a refund claim or to wait for the examinations. Many accountants prefer the latter course and resort to a refund claim only to avoid the outlawing of the credit. What type of record should be maintained to (a) make sure that credit is received when the examination is made, and (b) to insure that a protective claim will be timely filed if no examination is made?
2. Another common situation which requires a control mechanism deals with the filing of refund claims and avoidance of the risk of the running of the statute of limitations. When an accountant pre-

TAX INFORMATION — YEAR ENDED ______ 195__

Taxpayer(s)	Occupation	Social Security No.	Check if Blind	Over 65
Husband				
Wife				
Address				

DEPENDENTS

CHILDREN		CLOSE RELATIVES		Did Relative		Total Spent for Support By	
Name	Age	Name and Address (If not living with you)	Relationship	Reside with You	Receive Entire Support from You	You and Wife	Relatives & Others

Check If Taxpayer Is Head of Household (must be unmarried) ☐

Previous Tax Returns — Federal: Latest Year______ District Filed______ State: Latest Year______

	Salaries, Bonuses, Commissions and Other Compensation				
H or W	Name of Employer	City and State	S.S. Tax	Withholding Tax	Total Earnings

INCOME FROM INTEREST: Source	Amount
	$

INCOME FROM DIVIDENDS: Source	Amount
	$

OTHER INCOME (Attach Supporting Schedules)	State	Federal
Business Income	$	$
Partnership Income		
Rental Income		
Capital Gains and Losses		
Other Income: (Explain Nature)		

PAYMENTS OF ESTIMATED TAX Date	Amount
Overpayment Last Year	$
Total	$

In What District Was Return Filed

LOSS — CARRY-OVERS Explanation	Year from which Carried	State	Federal
Net Operating Loss			
Capital Losses			

Was Taxpayer In A Business or Corporation Which Liquidated During Year? Yes ☐ No ☐
If So, Are All Details Included Above? Yes ☐ No ☐

DEDUCTIONS

STANDARD DEDUCTION: Federal ☐ State ☐

If Both Federal and State Standard Deductions Are Not Checked Itemize Below

CONTRIBUTIONS:	$	
INTEREST (to whom paid):		
LOSSES FROM FIRE, CASUALTY, ETC.		
OTHER DEDUCTIONS: Traveling and Selling Expenses (Give Details)		
Union Dues		
Work Clothes, Uniforms and Cleaning		
Tools and Supplies		
LIFE INSURANCE: Husband		
Wife		

TAXES: State or City Income Taxes:	$	
State Unemployment Insurance		
Sales Taxes		
Gasoline Tax		
License Plates		
Real Estate and Property Taxes:		
Admissions and Excise Taxes (for State Only)		
MEDICAL AND DENTAL EXPENSES: (Submit Separate Schedule If Lengthy)		
Name of Doctor, Nurse or Hospital — Address		
OTHER MEDICAL EXPENSES:		
Prosthetic Devices, Trusses, Arch-Supporters, Etc.		
Eyeglasses		
Hospitalization Insurance		
Health and Accident Insurance		
Prescriptions and Medicines		
Total		

INSTRUCTIONS FOR FOLLOWING YEAR'S DECLARATION OF ESTIMATED TAX:

pares a refund claim for a client he must determine the following:

a) that the client received, signed, and mailed the form,

b) that the Collector received the form,

c) that the claim is acted upon before the statute of limitations on remedial action becomes operative.

How can compliance be reasonably and efficiently controlled?

Responses from readers are solicited.

Another Advance in Relation with Credit Executives

One of the major activities of our Society is the constant effort to maintain the most satisfactory relations with other groups, such as bankers, attorneys, credit executives, tax administrators, etc.; to join with them in educational activities; and to discuss and resolve mutual differences.

The Committee on Cooperation with Credit Men has, over many years, achieved outstanding results in creating a better understanding by credit men of the inherent limitations of audits, and of the confidential relationship between the accountant and the client. Accountants have learned from credit men how they can make their statements more informative.

In certain trades, where seasonal credit lines are abnormally large in relation to capital, there has been one area of irritation which, because of its delicacy, just needed time and understanding before it could be brought into the open for discussion.

This involved a complaint by some accountants that credit executives were interfering unduly in the selection and maintenance of auditors, and instances of plain favoritism. Also, that unfair and unreasonable pressure is exerted by some credit men for data beyond that specifically authorized by clients for release.

In fairness to credit executives it should be pointed out that, because of variations in audit and report standards among accountants, selectivity developed as a defensive measure. But, as can so easily happen in such circumstances, qualified accountants who were not well known to credit executives occasionally became the victims of such restrictive actions. The pressure for information, obviously, is a result of the large credit lines granted and the resultant high risks.

The present Accountants' Committee, under the chairmanship of Morton I. Davis, C.P.A., and largely at his urging, put these issues on the agenda of the recent annual dinner meeting with its counterpart committee of the New York Credit and Financial Management Association. It can be reported that the subjects, despite their delicate nature, were understandingly and sincerely received by the credit executives' committee.

Based upon the sympathetic and cooperative expressions of the credit men's committee there is good reason to believe that these views will percolate down to the rank and file credit executives, and that in time there should be a material alleviation of the conditions discussed. The committee and its chairman are to be congratulated on their willingness to spearhead this action and the satisfactory response is, in large measure, an evidence of the high esteem in which he is held by credit executives.

Let those accountants who feel aggrieved not expect an overnight change in attitudes and practices. Improvement will take time. However, a good start has been made and we look to the committee to continue their effective work.

Retainer Arrangements

The subject of fees has always been intriguing to accountants and perhaps always will be. Uniformity may never be achieved, and there is no good reason why charges should ever be fixed.

Personal services cannot be price-fixed like merchandise.

Annual retainers are a very common basis for monthly and other shorter-than-annual audits. Some uniformity may be achieved with respect to services that are includible within the retainer scope and those that are extraneous. Progress in this direction is bound to be an aid in the establishment of more adequate fees, and the reduction in controversies as to what constitutes a fair retainer amount.

The following is a basis for retainers which is worthy of consideration:

1. The retainer should cover services that are reasonably predictable as to volume and complexity. In this category, generally, are the following:
   a) auditing
   b) financial statement preparation
   c) preparation of tax returns — covering routine business transactions
   d) review of reports and tax returns with client.
2. By excluding the non-predictable items, the retainer can be made less speculative. Who will gain or lose on this basis is not a certainty.
3. Non-retainer items should be billable separately when, as, and if the services are performed. In these instances the fees should not be based on time alone, but on time and achievement factors. Services included in this category, patently, are those not covered by the retainer. The following are illustrations of such services:

   Extraordinary tax planning

   Attendance at tax examinations except, perhaps, when only minor problems develop

   Conferences on a high level, not dealing directly with financial statements and tax returns prepared

   Special investigations, etc.
4. In order that a client should not receive too many bills, non-retainer items might be billed semi-annually, or even annually.
5. In any event, clients should be advised that it is not intended under a retainer arrangement that unlimited services be rendered for a limited fee. This should be understandable by a fair-minded businessman and, if necessary, his own business operations might be used for illustrating the propriety of this point. Thus, even where routine services are involved, should it happen that because of sharply increased business volume, or because of difficulties within the client's own organization, the annual retainer is substantially inadequate, "renegotiation" of the retainer should be possible and a year-end adjustment be provided for. This is a delicate situation but, if deftly handled, can be worked out in many cases.
6. With new clients it should be possible to institute sound arrangements from the outset. Old clients may have to be brought around gradually and diplomatically.

The Excess Profits Tax Exchange

Conducted by DAVID ZACK, C.P.A.

THIS column is a clearing house for questions, problems and comments regarding Excess Profits Taxes. Items of general interest will be published herein and full credit will be given all contributors unless they request otherwise. All inquiries and contributions should be addressed to:

Editor, The Excess Profits Tax Exchange
The New York Certified
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New Corporations and War Contracts

A reader recently submitted the following question:

"May I express my appreciation to you and the editors of the New York Certified Public Accountant for your excellent presentation on a very difficult subject. I have one question though which I would appreciate your answering. In the January, 1952, issue, you referred to the restrictions placed upon "New Corporations", particularly the restricions that such corporations would not be entitled to benefits of lower rates if 50% or more of their business was subject to renegotiation. You further stated that gross income of renegotiable business was determined after cost of sales deducted. I am afraid I do not understand the allowances for cost of sales before determining the amount of business subject to renegotiation. Could you clarify that point further and provide me with a reference to the Renegotiation Account."

Section 430 (e) (3) of the Internal Revenue Code, as amended by the Revenue Act of 1951, provides as follows:

"LIMITATION—The provisions of paragraph (1) of this subsection (ceiling rates for new corporations) shall not apply to a taxpayer which derives more than 50 per centum of its gross income (determined without regard to dividends and without regard to gains from sales or exchanges of capital assets) for the taxable year from contracts and subcontracts to which the provisions of Title I of the Renegotiation Act of 1951 (or the provisions of any prior renegotiation act) are applicable."

The comment in the January, 1952, column referred to the fact that the statute, as set forth above, speaks of "gross income" rather than "gross receipts." The term "gross income" has definite significance in tax parlance and represents the so-called gross profit which remains after the deletion of the cost of goods sold from the gross sales. The statute would therefore seem to require a comparison of the gross income or gross profit from contracts or subcontracts subject to renegotiation with the total gross income of the taxpayer corporation, exclusive of dividends and capital gains, in applying the 50% test. This is in contradistinction to a mere comparison of the gross receipts or sales resulting from defense and civilian work. This distinction is particularly significant

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where, as is often the case, the margin of gross profit on civilian work is substantially greater than the gross profit percentage on government contracts subject to renegotiation. Thus it may easily be true that the limitation on the use of the special ceiling rates may not apply to a corporation whose renegotiable sales represent more than 50% of its total sales but whose gross profit from government contracts may be less than 50% of its total gross income.

It is interesting to note that the Senate Finance Committee Report on this section of the bill (Section 501 of the Revenue Act of 1951) makes it clear that the 50% gross income test is applied to all income to which the renegotiation laws are applicable whether or not the income is actually renegotiated. Thus, despite the fact that the Renegotiation Act of 1951 specifically exempts from renegotiation receipts and accruals of less than $250,000 in any taxable year, gross income from a government contract or subcontract which is subject to the Renegotiation Act of 1951 in an amount less than $250,000 could deprive a taxpayer of the benefits of the special excess profits tax ceilings for new corporations, if it represented more than 50% of the corporate gross income. However, neither the law nor the Committee Reports indicate whether the gross profit from government contracts is to be computed before or after renegotiation.

The Renegotiation Act of 1951 (P. L. 9, 82nd Cong. H. R. 1724) was approved by the President on March 23, 1951 and may be found in any book of Federal statutes and most commercial services on government contracts.

Relief Sections and Part IV

The following question points out a real limitation in the recently enacted Part IV of the Excess Profits Tax Law.

> "Is a purchasing corporation which qualifies under Part IV automatically barred from the other relief sections of the law (Secs. 442 to 446)? More specifically, if a purchasing corporation was organized after its base period, would it be entitled to new corporation relief under Section 445?"

Section 474(b) of the Internal Revenue Code (Part IV) provides that "the average base period net income of a purchasing corporation, if computed with reference to this part, *shall be determined under section 435(d)*" (emphasis supplied). This language indicates that a purchasing corporation which qualifies under Part IV must compute its average base period net income under the general average method provided by section 435(d). Inasmuch as the relief sections (Sections 442-445) provide for alternative computations of average base period net income, the purchasing corporation would seem to be foreclosed from the benefits of these relief sections, incluing section 445 with new corporations.

Computation of Maximum Tax For New Corporations

The following question raises an interesting point in the computation of the newly enacted maximum excess profits tax for new corporations:

> "In computing the tax for new corporations beginning after July 31, 1945, on their excess profits net income in excess of $300,000. for corporations whose taxable year began before April 1, 1951, and ended after March 31, 1951, is a straddle computation required using 15% and 18% and based on the number of days before and after March 31, 1951, or do we use the straight 18%?"

Section 430(e)(1)(E)(iii) of the Internal Revenue Code provides that the maximum tax shall be "if the taxable year (other than a taxable year described in clause (ii)) ends after March 31, 1951, an amount equal to 18 per centum of the excess of the excess profits net income for the taxable year over $300,000." However, this provision merely prescribes the rates applicable after March 31, 1951 and must be read in conjunction with Section 430(b) which specifically requires the

allocation of the rates applicable to the period before and after March 31, 1951 on a daily basis. The straddle computation using both 15% and 18%, based on the number of days before and after March 31, 1951 is therefore required. Part IV of the official Schedule EP (Form 1120) FY provides for this computation.

Growth Formula

The following question raises a very practical problem:

> "In determining if a corporation is entiled to use the alternative credit based on growth under Sec. 435 utilizing the gross receipts method, do we include the figure "gross sales" or "gross sales less returns and allowances" in computing the gross receipts?"

The statute (Sec. 435(e)(5)(A)) defines "gross receipts" as "the total amount received or accrued * * * from the sale, exchange" etc. There is no mention anywhere in the law about returns and allowances in this connection and the Regulations shed no light as they merely paraphrase the statute. However, it would seem to this writer that sales returns and allowances do not represent "amounts received or accrued" from a sale or exchange and that therefore, in computing "gross receipts" under the growth formula, "gross sales less returns and allowances" should be used.

Dividend "Throw-Back" re Base Period Capital Additions

This question highlights an important provision regarding base period capital additions.

> "In computing total assets for the computation of the base period capital addition in Schedule EP-2(a), the excess profits tax instruction sheet on Page 11 quotes Section 441(e) as follows: 'So much of the distributions to stockholders made during the first 60 days of *any taxable* year (other than the first taxable year ending after June 30, 1950) as does not exceed the accumulated earnings and profits at the beginning thereof shall be considered to have been made on the last day of the preceding taxable year.' Does the 'Throwback Rule' apply to all taxable years preceding as well as following, the first excess profits tax year or does it refer to *only excess profits* taxable years other than the first year?"

Section 441(e) of the Internal Revenue Code applies the 60 day throwback rule to the computation of the "invested capital, equity capital or accumulated earnings and profits as of the beginning of *any taxable* year" (emphasis supplied) "except in the case of the taxpayer's first taxable year ending after June 30, 1950." The rule therefore applies to all taxable years preceding, as well as following, the first excess profits tax year and is not at all limited to excess profits taxable years other than the first year. The application of this section to the computation of the base period capital addition will usually work out to the taxpayer's advantage.

Alternative Base Period Net Income For Certain Fiscal Year Taxpayers

The following question seems to carry the seeds of the answer within itself.

> "Section 435(d) allows an alternate base period for certain fiscal year corporations 'if such substitution produces a lesser tax for the taxable year for which the tax is being computed.' If a fiscal year corporation has *no tax* to pay for the current year, may it still use this alternative tax to gain a larger unused excess profits credit to be carried back and forward to other taxable years in order to reduce taxes?"

The quoted portion of Section 435(d) seems to so specifically limit the benefits of the option to the current year as effectively to prevent its use to swell an unused excess profits credit.

Book Reviews

Governmental Accounting

By R. M. Mikesell. RICHARD D. IRWIN, INC., Chicago, Ill.; 1951. Pages: x + 725; $8.00.

This book incorporates and elaborates on the principles and practices recommended by the Municipal Finance Officers Association of the United States and Canada and its National Committee on Governmental Accounting. In addition to the principal phases of Municipal Accounting covered in another standard text, the twenty-two chapters of this volume include a review of the accounting for educational institutions and hospitals.

There is also a section on Municipal Accounting Terminology, principally derived from the similar section of Municipal Accounting Statements, Bulletin No. 12 of the National Committee on Municipal Accounting. Definitions applicable to utilities are from the section on Terminology of the Manual of Water Works Accounting prepared jointly by the Municipal Finance Officers Association of the United States and Canada and the American Water Works Association.

A summary of principles and standard procedures recommended by the National Committee on Municipal Accounting and a standard audit procedure for municipalities are set forth, and the wide scope of this volume is further indicated in the introduction which points out that Accounting and Budgeting for the Federal Government as well as on the State and local level are included.

The timing of the publication apparentally did not permit a consideration of "Municipal Accounting and Auditing Publication No. 14 of the National Committee on Governmental Accounting" reviewed in *The New York Certified Public Accountant* in January, 1952. This review points out the change in title of the statement prepared by the Special Assessment Fund which was called "Statement Analyzing Changes in Reserve for Authorized Expenditures" and which is now entitled "Statement of Expenditures and Encumbrances Compared With Appropriations". The new caption, which is more descriptive, is not noted in this volume.

Despite the fact that other phases of governmental accounting are covered quite completely, no mention is made of accounting for municipal airports. This reviewer is particularly disappointed to note that no consideration was given to the subject of Airport Accounting in general or to Airport Cost Accounting, both of which were discussed in "Airport Accounting for the Port of New York Authority" by Karl G. Clement, in *The New York Certified Public Accountant*, April 1951. Here again the timing of publication may not have permitted inclusion of this material.

A clear presentation is made of the concept of Performance Budgeting brought to prominence by the Commission on Organization of the Executive Branch of the Government (the "Hoover Commission") illustrated by examples from the budget of the City of Richmond, Virginia.

On the perennial question of compensation of governmental auditors, the author points out that the State of Idaho has partially met the difficulties involved in flat fee bids in negotiation with private accountants for auditing service by providing for the submission of bids on any one of the following three bases:

1. Per diem.
2. Per diem with maximum fee.
3. Flat fee.

It is pointed out that the multiple basis for bidding is conducive to securing offers from fully qualified professional accountants who would refuse to compete if flat fee bids only were acceptable. Unfortunately it does not overcome the limitation of a fixed amount appropriation for the audit fee.

It is possible to criticize undesirable practices in State and local government units without specifying what particular municipalities are the offenders. This anonymity is obviously impossible in referring to the Federal Government. Perhaps in order to avoid what might be a highly controversial subject the author limits himself to the statement that "while many small and medium sized municipalities have excellent accounting and budgeting systems . . . the accounts of the Federal Government do not even represent a complete set of books." There may be many who would wish that the budget of the Federal Government could be made digestible by the legislators, if not by the general public. In his conclusion the author cites the importance of auditing and reporting in protecting the taxpayer's financial interest, ending on the gloomy but undoubtedly realistic note that "it must be admitted, however, that the real use of governmental financial reports by the general public is so slight as to be almost negligible."

Since governmental activities are becoming more complex on all levels it is increasingly important that the facts of government man-

agement be presented clearly to the public, who have the final responsibility. The growth of literature in the field of governmental accounting is, therefore, encouraging since many of the facts can be presented through the medium of financial reports. Every accountant, as a citizen, is concerned with the financial control, accounting and reporting of the various government units which serve him. If the reporting of the facts improves, it may lead to a better policing of governmental activities on all levels. This book, therefore, as a clear presentation of the principles involved should prove a definite contribution to better governmental accounting and reporting.

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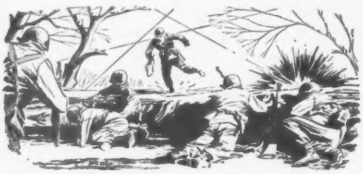
Captain Raymond Harvey Medal of Honor

THE 17TH INFANTRY REGIMENT was attacking Hill 1232 near Taemi-Doug, Korea. Able and Baker Companies became split by a Red-held ridge. Charlie Company, Captain Harvey commanding, was moving up to fill the gap when the dug-in Red guns pinned it down. Calling for covering fire,



Captain Harvey advanced *alone* through a hail of enemy bullets. One by one, he personally wiped out four emplacements of machine guns and automatic weapons. Then he caught a bullet through the lung. But he stayed on, refusing evacuation, until sure the objective had been won.

"In Korea," says Captain Harvey, "we stopped aggression by *united* strength. *You* were helping—every time you bought a Defense Bond. Because your Defense Bonds were doing more than just helping keep you, and your family, and your country financially stable. They were backing *us* up in the field with *American production power*, the surest support any fighting man can have!

"I hope you'll go on buying Bonds—many, many of them. For your Bonds—and our bayonets—are making America strong. And in today's cold-warring world, *peace is only for the strong.*"

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Remember that when you're buying bonds for national defense, you're also building a personal reserve of cash savings. Remember, too, that if you don't save *regularly*, you generally don't save at all. So sign up today in the Payroll Savings Plan where you work, or the Bond-A-Month Plan where you bank. For your country's security, and your own, buy United States Defense Bonds now!

Peace is for the strong... Buy U. S. Defense Bonds now!

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